



December 13, 2011

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 37

Board Members:

Microsoft's Audit Committee appreciates the opportunity to provide comments on the PCAOB's Concept Release, "Auditor Independence and Audit Firm Rotation." We share the PCAOB's desire to assure that auditors approach the audit with the required independence, objectivity, and professional skepticism. However, we disagree that mandatory auditor rotation would significantly enhance auditor independence, objectivity, and professional skepticism, especially in light of the substantial risks to audit quality and direct and indirect costs of changing audit firms. Additionally, we do not believe the proposal recognizes the critical role that audit committees serve in governance and oversight of the independent auditor and company management and the positive impact of those activities on audit quality.

Audit Committee Governance and Oversight

We recognize the importance of maintaining the independence of Microsoft's independent auditor, both in fact and appearance, and rigorously approach our responsibility for oversight of the auditor. At least annually, we evaluate the independent auditor's qualifications, performance, and independence, including that of the lead partner. The evaluation includes obtaining and assessing a written report from the independent auditor describing:

- The firm's internal quality control procedures;
- Any material issues raised by the most recent PCAOB inspection, internal quality control review, or peer review, of the firm or by any inquiry or investigation by government or professional authorities within the past five years, concerning an independent audit or audits carried out by the firm, and any steps taken to address those issues; and
- All relationships between the independent auditor and the company.

In addition to this evaluation, we have numerous other procedures for assessing the independence, objectivity, and professional skepticism of the audit firm in conducting its audit, including:

- Reviewing the audit scope and plan, and any changes thereto, with the independent auditor.
- Review and discussion of the company's critical accounting policies and significant judgments and estimates with the independent auditor.
- Ascertaining whether there were any difficulties encountered in the course of the audit work of the independent auditor, including any restrictions on the scope of their work or access to information.
- Reviewing with the independent auditor alternative treatments of financial information within generally accepted accounting principles related to material items that have been discussed with management, ramifications of use of the alternative disclosures and treatments, and the treatment preferred by the independent auditor.
- Twice quarterly private sessions with the independent auditor providing a vehicle for direct governance and supervision.

We believe that our governance and oversight are effective mechanisms in ensuring the independence, objectivity, and professional skepticism of the audit firm in conducting its audit.

We believe a requirement for mandatory auditor rotation could actually restrict our ability to provide effective oversight. Our ultimate governance and oversight over the independence of the auditor is our responsibility to appoint or replace the auditor (subject to shareholder ratification) and approve the terms (including compensation) on which the auditor is engaged for the ensuing fiscal year. Given the significant risks and costs of an auditor rotation, we can envision an unwarranted reluctance to voluntarily change audit firms in an environment of mandatory auditor rotation, although facts and circumstances may call for that type of action.

We also believe that audit quality in general has been greatly enhanced since the passage of the Sarbanes-Oxley Act of 2002 ("S-Ox") supported by the following regular activities:

- Financial management, internal audit, and the independent auditor review and discuss significant estimates and judgments with the CEO and CFO each quarter

and annually to ensure high quality financial reporting and as part of the certification under S-Ox Sections 906, 302, and 404.

- The audit committee discusses and reviews key accounting matters and any unusual transactions with financial management and the certifying officers each quarter. The independent auditor participates in these reviews and freely expresses their assessment of the company's accounting and disclosures in relation to such matters and transactions.
- The independent auditor works closely with the chief audit executive (who reports to the audit committee) to ensure the audit scope and plan address the significant risks to effective financial reporting.

In addition to these regular activities, we believe the mandatory audit partner rotation requirements of S-Ox have improved audit quality. Unlike the mandatory audit firm rotation proposal, the current audit partner rotation requirement allows for fresh views to be brought to the audit team, while allowing a company and its audit firm to stagger other rotations within the audit engagement team to ensure a continuity of in-depth understanding of the control environment and issues facing the company.

Direct and Indirect Costs

We believe a requirement for mandatory auditor rotation will result in significant increased costs that need to be taken into consideration in examining whether the benefits of such a requirement would outweigh the costs. These increased costs include higher audit fees and increased costs at companies caused by the disruptive impact of a change and the need to educate a new audit firm about their business and operations.

The 2003 GAO Study on the Potential Effects of Mandatory Audit Firm Rotation indicated that nearly all Tier 1 audit firms estimated that initial year audit costs under mandatory audit firm rotation would increase by more than 20 percent over subsequent year costs to acquire the necessary knowledge of the public company, and most of the Tier 1 firms estimated their marketing costs would also increase by at least more than 1 percent, which would be passed on to the public companies. That report also indicated that most Fortune 1000 public companies estimated that under mandatory audit firm rotation, they would incur auditor selection costs and additional auditor support costs totaling at least 17 percent or higher as a percentage of initial year audit fees.

Another significant potential cost of mandatory rotation would arise from trying to assure that another audit firm is deemed independent with respect to non-audit services when the time comes to mandatorily change audit firms. As a large multinational corporation, Microsoft engages the other large accounting firms other than its independent auditor to provide numerous non-audit services, such as services related to cloud computing infrastructure, venture integration of new or acquired businesses, and

various go-to-market initiatives. We believe trying to ensure at least one of these firms was independent for purposes of mandatory auditor rotation would cause a significant disruption to important projects and go-to-market initiatives given Microsoft's partner business model.

Risks of Mandatory Auditor Rotation

In addition to the direct and indirect costs of mandatory auditor rotation, we believe there are significant risks for audit failure from such a requirement. The 2003 GAO Study on the Potential Effects of Mandatory Audit Firm Rotation indicated that about 79 percent of Tier 1 audit firms and Fortune 1000 public companies believe that changing audit firms increases the risk of an audit failure in the early years of the audit as the new auditor acquires the necessary knowledge of the company's operations, systems, and financial reporting practices and therefore may fail to detect a material financial reporting issue.

Besides the risks from the learning curve that will be encountered by a new auditing firm, we believe a requirement for mandatory auditor rotation also creates risks towards the end of a rotation period. One of the arguments put forth for mandatory auditor rotation in the Concept Release is that, "By ending a firm's ability to turn each new engagement into a long-term income stream, mandatory firm rotation could fundamentally change the firm's relationship with its audit client and might, as a result, significantly enhance the auditor's ability to serve as an independent gatekeeper." We believe the opposite impact may be more likely. A mandatory auditor rotation requirement, which has the effect of ending a potentially stable long-term fee arrangement, will actually increase the pressure for some sort of fee replacement once the audit engagement ends. In our opinion, this significantly increases the potential risk for an audit firm to compromise its independence, objectivity, and professional skepticism in the last few years prior to a mandatory rotation to gain a favorable impression with company management in order to secure non-audit services to the client once the audit engagement ends.


We were surprised that the Concept Release had only one sentence on this potentially significant adverse risk from a mandatory auditor rotation requirement, indicating that "On the other hand, independence could suffer if firms—knowing that their audit engagement is about to come to an end—begin to focus on marketing future non-audit services to the audit client". We believe the PCAOB should do significantly more analysis of this real adverse risk of a mandatory auditor rotation requirement. Finally, another risk is that the outgoing audit firm may redirect key engagement resources to newer engagements towards the end of a rotation period.

As mentioned previously, Microsoft's Audit Committee shares the PCAOB's desire to assure that auditors approach the audit with the required independence, objectivity, and professional skepticism. However, in order to overcome the substantial direct and


indirect costs and risks of a mandatory auditor rotation requirement, there should be compelling and not just reasonable arguments to support change. We believe the Concept Release fails to make that compelling argument, in particular, in adequately examining the governance and oversight audit committees provide over the independent auditor or fully considering the potential risk for an audit firm to compromise its independence, objectivity, and professional skepticism in the last few years prior to a mandatory rotation.

Sincerely,

The Audit Committee of the Board of Directors of Microsoft Corporation


Charles H. Noski, Chairman


Dina Dublon


Dr. Helmut Panke