COMMITTEE ON CAPITAL MARKETS REGULATION

December 14, 2011

Mr. J. Gordon Seymour
Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Re: Concept Release on Auditor Independence and Audit Firm Rotation Release No. 2011-006, Rulemaking Docket Matter No. 37

Dear Mr. Seymour:

The Committee on Capital Markets Regulation (Committee)[*] appreciates the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB) concept release on Auditor Independence and Audit Firm Rotation.[1]

Since 2005, the Committee, composed of 32 members, has been dedicated to improving the regulation of U.S. capital markets. Our research has provided an independent and empirical foundation for public policy. In May 2009, the Committee released a comprehensive report entitled *The Global Financial Crisis: A Plan for Regulatory Reform*, which contains fifty-seven recommendations for making the U.S. financial regulatory structure more integrated, more effective, and more protective of investors in the wake of the financial crisis of 2008.[2] Since then, the Committee has continued to make recommendations for regulatory reform of major areas of the U.S. financial system.

We support the PCAOB's stated goals of enhancing auditor independence, objectivity and professional skepticism. We agree with the PCAOB that these qualities are critical to the viability of the audit profession,[3] and furthermore, that improvement in these areas should be an ongoing goal of audit firms. The issue of auditor independence is not a new one; as the PCAOB notes, various proposals to enhance auditor independence and audit quality, including mandatory audit firm rotation, have been considered periodically in the U.S. since the 1970s.[4]

Mandatory audit firm rotation would impose significant costs both on audit firms and on companies. Transitioning to a new audit firm will result in the loss of institutional knowledge, including both an audit firm's substantive knowledge of a company as well as its practical knowledge (for example, knowledge of a company's accounting and recordkeeping systems,

[*] Note one member of the Committee has abstained from taking a position on the issues addressed in this letter.
[1] Concept Release on Auditor Independence and Audit Firm Rotation, PCAOB Release No. 2011-006, Rulemaking Docket Matter No. 37 (proposed August 16, 2011) [hereinafter Concept Release].
[2] COMM. ON CAPITAL MKTS. REG., THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM (May 2009), http://www.capmktsreg.org/research.html.
[3] Concept Release, p. 4.
[4] Concept Release, p. 2.

internal contacts, etc.). These costs take several forms: there would be financial costs as the auditors must educate themselves about their new client and its operations, as well as costs incurred by companies who will be required to expend significant time and resources researching, assessing, and selecting new auditors and then bringing them up to date on the company's business. There could be potential costs related to audit failures which the 2003 report by the General Accounting Office (GAO) indicated are more likely in the early years of an audit.[5] These findings are consistent with the results of a study by the Commission on Auditor's Responsibilities (the Cohen Commission) in 1978, which concluded that any benefits that might be gained from mandatory rotation would be offset by the loss of benefits from a continuing relationship.[6] The Concept Release also references academic studies that indicated fraud is more likely to occur in the early years of an audit relationship.[7]

There are other firm-specific issues raised by mandatory rotation and a risk that forced rotation will result in sub-optimal audits in the first years of engagement.[8] Particularly for companies who choose to be audited by big four accounting firms, in selecting a replacement audit firm, these companies may be forced into a sub-optimal choice. The PCAOB acknowledges that "[f]or many companies, particularly large, multinational ones, there may be a practical limit to the number of audit firms to choose from."[9] Because of existing restrictions on firms obtaining different types of service from audit firms, if a firm already has one of the big four providing tax advisory services, for example, it will be left with a smaller pool of replacement firms to choose from. Furthermore, certain audit firms have developed industry-specific expertise that may effectively limit a company's choice of auditor. These issues may be magnified for multinational companies who require audit services in multiple jurisdictions. The PCAOB also suggests that as a result, other firms might develop additional capacity and expertise to take on these engagements;[10] it would be unwise, however, to implement a rule whose success depends on such an evolution of the audit industry in the short-term.

On the other hand, the PCAOB has presented no empirical evidence to suggest that mandatory audit firm rotation would improve auditor independence and skepticism. The PCAOB acknowledges that professional skepticism is a state of mind and may be difficult to identify as the cause of an audit failure, and that "audit failures can also reflect a lack of technical competence or experience."[11] Perhaps more importantly, a preliminary analysis of the PCAOB's inspection data "appears to show no correlation between auditor tenure and number of comments in PCAOB inspection reports."[12] Academic research suggests similar conclusions. Researchers

[5] Concept Release, p. 14. The GAO study included results of a survey of public accounting firms and public companies, which found that 79% of these firms and Fortune 1000 companies believed changing audit firms increases the risk of audit failure in the early years of the audit, and rotation would increase initial year audit costs by more than 20%.
[6] Concept Release, p. 11.
[7] Concept Release, p. 16.
[8] See Lucio Noto, *Term Limits will Diminish the Quality of Multinational Audits*, WSJ.COM (Nov. 28, 2011), http://blogs.wsj.com/cfo/2011/11/28/term-limits-will-diminish-quality-of-multinational-audits/.
[9] Concept Release, p. 21.
[10] Concept Release, p. 21.
[11] Concept Release, p. 6.
[12] Concept Release, p. 16.

who studied mandatory audit firm rotation in Korea did not find increases in audit quality.[13] To the contrary, the PCAOB references a number of studies on auditor tenure and audit quality that support the view that shorter engagements are relatively riskier.[14] Regardless of potential limitations to these studies as outlined by the PCAOB, it seems extremely ill-advised to implement mandatory audit firm rotation, with its enormous known costs, without strong empirical evidence that the proposal will achieve the PCAOB's goal of enhancing independence, objectivity, and skepticism.

We reiterate that robust cost-benefit analysis is critical if the PCAOB decides to take further action on this proposal. The SEC has oversight authority over the PCAOB and must approve the PCAOB's rules.[15] As a result, the SEC and PCAOB together should continue to collect and analyze information relating to the costs and benefits of mandatory audit firm rotation. In light of the ruling this past July by the U.S. Court of Appeals for the D.C. Circuit in *Business Roundtable v. Sec. and Exch. Comm'n*,[16] a rule regarding mandatory audit firm rotation could be subject to successful challenge in the courts if it does not exhibit adequate cost-benefit analysis.

Although the Concept Release is focused on audit firm rotation in particular, other proposals are also suggested, including joint audits, mandatory retendering, audit-only firms, tenure protection, changing the audit firm payment model, selective rotation, enhanced audit committee oversight, and others. All but two of these proposals present significant practical obstacles and costs while again no empirical data has been provided to suggest their benefit.[17] Enhanced audit committee oversight and selective rotation (in the event a PCAOB investigation has uncovered lack of independence, objectivity, and skepticism) could, in theory, provide benefits. However, before moving forward with either proposal, the PCAOB must further consider precisely how such proposal would be implemented, and what the costs and benefits of such proposal would be. In the case of selective rotation, a proposal would need to ensure that the cause of the audit failure was actually a lack of independence, objectivity, and skepticism, rather than a simple mistake, particularly in light of the enormous consequential costs of rotation.

Thank you for considering our comments. Please do not hesitate to contact us at (617) 384-5364 if we can be of any further assistance.

Respectfully submitted,

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R. Glenn Hubbard	John L. Thornton	Hal S. Scott
CO-CHAIR	CO-CHAIR	DIRECTOR

[13] Ernst & Young, Comment Letter for Docket 037, p. 8, http://pcaobus.org/Rules/Rulemaking/Docket037/063_EY.pdf, citing "Auditor Tenure and Auditor Change: Does Mandatory Auditor Rotation Really Improve Audit Quality?", Working Paper, Bocconi University and IE Business School, M. Cameran, A. Prencipe, M. Trombetta, 2010; and "Mandatory Audit Firm Rotation and Audit Quality: Evidence from the Korean Audit Market," Soo Young Kwon, Youngdeok Lim, and Roger Simnett (November 19, 2010).
[14] Concept Release, p. 16.
[15] 15 U.S.C. § 7217(a).
[16] Business Roundtable v. Sec. and Exch. Comm'n, 647 F.3d 1148 (D.C. Cir. 2011).
[17] *See* European Commission, *Green Paper, Audit Policy: Lessons from the Crisis*, COM (2010) 561 final (Oct. 13, 2010). The Green Paper also presents the alternatives of joint audits, mandatory retendering, and audit-only firms. Commenters have voiced concerns over all of these proposals.