Comment by John H. Biggs, Retired Chairman and CEO of TIAA-CREF on the Concept Release on Auditor Independence and Audit Firm Rotation

Submitted to the Office of Secretary, PCAOB, referring to PCAOB Rulemaking Docket Matter No.37, November 21, 2011

I'm pleased that the PCAOB is giving consideration to requiring that public companies periodically rotate their audit firms.

In the following comments I finally conclude that I recommend that the PCAOB and the SEC impose mandatory firm rotation after 10 years, which would coincide with the second statutorily required rotation of the managing auditor. If this is deemed too strong medicine, I would recommend at a minimum that the SEC require in the proxy that the company disclose the years of tenure of the audit firm, which is surely an item of importance to users of the statements.

.This consideration is timely, since 8 years have elapsed since the GAO did the study required by Sarbanes Oxley (SOX), The data in that study was surprising and disturbing: 37% of Fortune 1000 companies having had the same auditor for over 20 years (GAO data in 2003, which is probably much higher today). That seems to me too long for investors to have confidence in the independence of the audit firm. After the discussions surrounding SOX many directors did begin considering rotation of the auditor as a "best governance practice." I believe that most auditors, preparers and, especially, audit committees of Boards increased substantially the care that they took in assuring the true independence of their audit firm

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Over the last ten years, since I retired from TIAA-CREF, I have been on the audit committees of two of the largest American companies, one a major banking company and the other one of our top industrial companies, where I chaired its audit committee. Both companies had a long relationship with the same audit firm of over 20 years. However, I observed in both of those companies a much more careful and professional relationship between the management and the auditor than before the Enron and WorldCom experiences and the passage of SOX. They clearly understood that the independence of the auditor was an important part of good corporate governance. In both companies the CEO did not attend the audit committee meetings. They did so explicitly in order to make clear the committee's freedom to ask any questions they wanted of the financial management. (Before SOX I always attended TIAA-CREF's audit committee meeting but now that we have heightened concern about independence, I think it is good practice for CEO's to leave the conduct of audit committee to its chair with only senior financial executives attending.) In both companies the auditor worked with the chairs and members of the committees on a background basis between meetings. Relationships between management and the auditor were civil and, business like, but with both understanding their roles. There was little entertaining and personal relationship building between the audit firm and senior management. I frankly felt that the independence of the auditor existed in these two companies, and that the 5 year senior partner's rotation, but not the firm's, was doing the job.

However, now I am concerned that, after the extensive examining of firms' auditor independence and professional skepticism, some of the PCAOB board and staff believe we have failed to get across the message of this crucial quality of the auditing process. I would have thought that the message of the revolutionary audit changes required by SOX, and the experiences of Enron, WorldCom and Arthur Andersen, and the resulting punishment of the officers and firms themselves, would have penetrated deeply into the culture of corporate America and especially into the culture of the surviving four audit firms.

On the other hand, I recently had a testy conversation with the former CEO of a very major financial institution who vigorously opposed rotation and was proud of the fact that his company had the same audit firm for over 100 years. He insisted on the quality of their "partnership"—a word used heavily by Ken Lay at Enron and Arthur Anderson in promoting Anderson's services to other clients. Can a "partner" be independent? In my experience, we would never have used that word to describe our auditors' relationship to management. The auditor has an extremely important role; to assure investors and creditors that managements' numbers have been independently verified and with professional skepticism. Users of statements should be very skeptical of a hundred year "partnership" with the claim of an independent audit.

When I was Chairman and CEO of TIAA-CREF (1993-2002) we had 2 rotations of our audit firm, following a rotation policy adopted by the company in the 1950's, as recommended the company's CEO, William Greenough, who was a pioneer in many aspects of good corporate governance, both at TIAA-CREF and other institutions—especially the NYSE where he fought long and hard, and finally successfully, to eliminate fixed commissions.

Both rotations, during my decade of leadership, had the effect of strengthening our company's audit and, in my recollection, did not result itself in higher fees. It also instigated a healthy review of our company's financial management policies and practices.

I described our experience in testimony before the Senate Banking Committee chaired by Senator Sarbanes, as that committee was considering the auditing provisions of what became SOX. I recommended rotation in that testimony, which I believed would limit what seemed to me a seriously flawed business model of the auditing profession. In fact many of the other provisions of SOX, that were adopted, aimed at correcting that model. In particular, SOX eliminated the abusive use of the audit relationship and the brand names of the firms to sell non-audit "services" of all types; from technology consulting to tax advice to executive relocation services.

We rotated the auditor after 7 years and followed a process that focused on the <u>quality</u> of the senior audit staff of the firm proposing to us.

TIAA-CREF during those years was the largest real estate investor in the U.S. and had great complexity not only in those positions but also in the usual investments of an institution of great size. We managed over $300 Billion in the year 2000. Also, the TIAA component of TIAA-CREF was a life insurance company subject to a complex taxation model. Accordingly, we wanted top expertise in real estate investing, taxation, technology and other focus areas. Since we had 4 firms, of the 5 at that time, competing for the assignment, we interviewed outstanding talent.

We did not include price in our request for proposal but negotiated that after our decision was made. I do not recall any significant rises in fees in spite of our rapid growth in size and complexity during those years. Neither of the winning firms saw a need for anything like a 20% increase in their first year costs (as suggested by the GAO study) and proclaimed by opponents of mandatory rotation. Surely the Big 4 firms have the depth of staff and other resources to get up to speed quickly.

In general, we valued very highly the expertise the audit firm brought to our company, and we did all we could to avoid the usual "box ticking" audit relationship.

Furthermore, TIAA-CREF at that time was especially active in corporate governance issues, and was the only non-public investment institution raising questions with management about a broad variety of governance issues. Just before SOX was enacted, we had decided to file proxies at a number of American public companies which had the following characteristics: (1) they had the same audit firm for 20 or more years (2) had consulting fees that exceeded their audit fees and (3) had senior financial officials who were former partners of the firm. We had many companies who met the criteria (especially Enron, who had all 3 and, in addition, Anderson performed the company's internal auditing function and some controversial investment banking work). If a company had the 3 criteria, we believed the auditor could no longer be seen by investors as independent, and we would request the company to rotate to a new audit firm. We never filed the proxies since we decided that SOX would achieve the fundamental changes that we sought.

I regretted that the Sarbanes Committee did not include rotation in its bill; however, the law did require the General Accounting Office (GAO) to do a study of the need for rotation. I was deeply disappointed in reading the GAO report with its inherent bias. They interviewed primarily auditors and preparers who were well-known to be strongly opposed to rotation. It is not surprising that these 2 groups would conclude that costs would exceed benefits, and came up with the extraordinary claim that the first year additional cost for auditors would rise by 20%. That number seems to me to have no real basis other than the guess of people who were eager to see the cost exceed the benefits. And even if one accepts this high number, when the cost is spread over 10 years it comes to only a 2% increase which is in the statistical noise of audit fees.

The GAO Report did refer to the recommendation, advocating rotation, of the Conference Board Commission on Public Trust and Private Enterprise. That Commission broadly represented the investment community –the members included Jack Bogle and me representing Vanguard and TIAA-CREF, Peter Gilbert, the Chief Investment Officer of the Pennsylvania State Employees Retirement System, and Arthur Levitt, Charles Bowsher and Paul Volcker with prior experience in government relations along with CEO's of major companies, including John Snow, the future Secretary of the Treasury.. The GAO report recites the provisions of the Conference Board report, which were similar to the above cited views of TIAA-CREF, and did agree "audit committees that encounter those circumstances, at a minimum, need to be especially vigilant in the oversight of the auditor and in considering whether a "fresh look" (e.g. new auditor) is needed, *page 9, of GAO November 2003 Report to the Senate Banking Committee.*

None of the benefits I pointed out in my testimony before the Sarbanes Committee were mentioned – they probably did not read my testimony which was from the point of view of the CEO of one of America's largest investment institutions and a person with extensive experience and oversight of the accounting and auditing professions (membership in the Public Oversight Board, the Financial Accounting Foundation, and the International Accounting Standards Committee Foundation). They certainly did not interview me to inquire about my concerns. They did say they that had run the results by several investment institutions but that was a secondary interest, with little disclosure of how they selected the several institutions.

The 2003 GAO Report did include the following statement on *page 8*: *"However, it will take at least several years for the SEC and PCAOB to gain sufficient experience with the effectiveness of the act (SOX) in order to adequately evaluate whether further enhancements or revision, including mandatory audit firm rotation, maybe needed to further protect the public interest and to restore public confidence"*.

More than "several years" have passed, and the financial collapse of 2008-2009 certainly suggests that public confidence still needs to be restored in the financial management of our banking institutions. In particular, investors have to wonder about the independence and professional skepticism of the auditing profession.

In the two decades prior to the collapse, both firms and auditors put enormous stress on "risk management." In the autopsies of the failed firms, it has become clear that "risk management" were words not deeds. In the PCAOB August Concept release there are the chilling words that the PCAOB 2010 inspections "were astonished to find significant deficiencies related to the valuations of complex financial instruments."

There has been much criticism of sloppy underwriting by bank and securities firm, and of the rating agencies' lack of reasonable skepticism. But shouldn't there have been some skeptical auditors, of say, Triple A valuations of CDO's based on sub-prime mortgages?

The discussion by the PCAOB is surely timely. At least, the SEC should require disclosure in the proxy of the tenure of a company's auditor. That alone might increase the likelihood that audit committees would consider their obligations under SOX to appoint an auditor with a "fresh point of view".

While on the Public Oversight Board, I was impressed with the achievements of the peer review processes the firms allowed us to oversee. Although there appeared to be no significant public disclosure of problems, in fact many problems were solved quietly and out of sight.

I believe rotation produces a kind of “real time” peer review. The outgoing auditor wants the work papers to be complete and of high quality with all problems clearly resolved. The new firm reviews them and could either challenge their results, or start with fresh eyes.

I have heard criticisms that if a management is designing fraudulent or questionable accounting practices, it would be easy for them to deceive a new auditor. I believe the opposite is true. Both audit firms would be alert to an issue and both would wish to smoke out problems before and after the change over

Thank you for considering my observations.