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June 25, 2012

**Via Email: [comments@pcaobus.org](mailto:comments@pcaobus.org)**

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

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

Ladies and Gentlemen:

This letter is submitted on behalf of the Federal Regulation of Securities Committee and the Law and Accounting Committee (the "**Committees**" or "**we**") of the Business Law Section (the "**Section**") of the American Bar Association (the "**ABA**") in response to the request for comments by the Public Company Accounting Oversight Board (the "**Board**") in the concept release referenced above (the "**Concept Release**").

The comments expressed in this letter represent the views of the Committees only and have not been approved by the ABA's House of Delegates or Board of Governors and therefore do not represent the official position of the ABA. In addition, these comments do not represent the official position of the Section.

**A. Overview**

The Committees agree with the Board that independence and objectivity are fundamental to the audit profession and to the integrity of financial statement audits. However, we believe that an audit firm rotation requirement, as envisioned by the Concept Release, could have significant adverse consequences to audit firm clients and severely inhibit the ability of listed company audit committees to discharge their statutorily imposed responsibilities. Before proceeding further, the Board should thoroughly review and assess the costs that implementation of an audit firm rotation requirement would entail and make clear its legal authority to establish such a requirement.

**B. Mandatory audit firm rotation could have significant adverse consequences to audit firm clients by requiring audit firm clients to engage audit firms that may be less capable than the firms they are replacing.**

In choosing auditors, audit committees carefully evaluate the attributes of the various audit firms they are considering. Among these attributes are the expertise of an audit firm in the particular industries or lines of business in which the company is engaged; the availability of audit firm resources in the various locations in which the company operates; the impact on independence in light of prior or proposed non-audit services that have been, or may be, provided by the audit firm or its affiliates; prior relationships the company may have had with the audit firm and the ability of the audit firm to be responsive in a variety of situations, such as in connection with capital markets transactions. If periodic audit firm rotation is mandated by the Board in order to achieve a perceived benefit to independence, the range of choice that audit committees have in connection with the selection of auditors would be reduced, and perhaps in some cases eliminated, and companies may be required to engage audit firms that are not as well qualified as the audit firms they replace.

We believe the greatest burdens associated with a periodic audit firm rotation will be experienced by smaller reporting companies that may not have the financial resources to bear the economic consequences that periodic audit firm rotation would entail, and by larger companies operating in numerous jurisdictions worldwide. The number of audit firms that have the expertise, including in specialized industries such as the utility and oil and gas sectors, and geographic presence to meet the needs of these multinational companies may be limited, and this pool may be further reduced by the elimination of firms that, for any number of reasons, may be deemed not to be independent. As a result of this limited pool, the quality of the audit services provided to a company by the successor auditor may not be as high as the services provided by its predecessor, and the costs associated with the audit, especially if the audit firm does not have local resources, may be substantially increased. We are therefore concerned that companies will incur significant costs in order to obtain benefits that may be only speculative and that can be achieved in other ways.

In addition, a mandatory rotation requirement would create particular difficulties in the mutual fund industry. It is often the case that mutual funds have a different auditor than the financial services firm whose affiliate is engaged to serve as the advisor to the mutual funds. In these situations, both audit firms are typically restricted by independence rules from providing impermissible non-audit services to the mutual funds and the financial services firm and its affiliates. Requiring rotation in this setting would result in significant disruption and could create difficulties in identifying audit firms that are well positioned to provide quality audits to all parties that require independent auditors.

We strongly encourage the Board, prior to proposing any mandatory audit firm rotation requirement, to consider carefully the potential that such a requirement may force companies to select from a group of audit firms that are not as well suited for the engagement as the current auditor.

**C. Mandatory audit firm rotation would be inconsistent with audit committee responsibilities under the Sarbanes-Oxley Act and the SEC's rules thereunder.**

We believe that an auditor rotation requirement could undermine an audit committee's responsibilities under Section 301 of the Sarbanes-Oxley Act of 2002 (the "*Act*") and the rules of the Securities and Exchange Commission ("SEC") implementing that section, as well as other corporate governance goals, and that it may inadvisably constrain the authority and discretion of audit committees to act in the best interests of their companies.

Section 301 of the Act addresses the role and responsibilities of listed company audit committees. Section 301 requires that:

The audit committee of each issuer, in its capacity as a committee of the board of directors, *shall be directly responsible* for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the audit committee.<sup>1</sup>

The SEC implemented the provisions of Section 301 in Rule 10A-3 under the Securities Exchange Act.<sup>2</sup> As the SEC stated in its adopting release:

[O]ne of the audit committee's primary functions is to enhance the independence of the audit function, thereby furthering the objectivity of financial reporting. ... One way to help promote auditor independence, then, is for the auditor to be hired, evaluated and, if necessary, terminated by the audit committee. This would help to align the auditor's interests with those of shareholders.

Congress therefore mandated, and the SEC implemented, rules that promote the independence of audit functions by vesting the responsibility for hiring auditors in a listed company's audit committee. In our view, this responsibility can only be effectively discharged if the audit committee can broadly consider a full range of factors, and is not constrained by rigid criteria that would disqualify an auditor from being able to continue to serve, even where the audit committee has determined that such continued service would be in the company's best interests. As the Act contemplates, the audit committee is best positioned to assess and weigh these various factors. We believe that a mandatory rotation requirement would work at cross-purposes to the responsibilities that Congress and the SEC expressly imposed on listed company audit committees, and that limiting the authority of audit committees in this manner would be contrary

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<sup>1</sup> Sarbanes-Oxley Act § 301(2) (emphasis added).

<sup>2</sup> See Standards Relating to Listed Company Audit Committees (Apr. 9, 2003), SEC adopting release at <http://www.sec.gov/rules/final/33-8220.htm>.

to sound Congressional policy.<sup>3</sup> In this connection, we note that the Act and existing SEC rules require audit partner rotation, so that new personnel, and new perspectives, are brought periodically to the audit process. By requiring audit partner rotation, the potential for an entrenched audit partner to lose objectivity or fail to comply with other required auditing standards is minimized or eliminated.

Second, we believe, from a governance perspective, that mandatory audit firm rotation would impose significant additional burdens on audit committees and company management. Changing auditors is both time-consuming and expensive. The audit committee and management of a company would need to expend considerable time and effort to acquaint the new auditor with the business, management, internal procedures, and internal control and compliance systems of the company. In addition, prior auditors may have achieved a level of institutional knowledge with respect to an audit client that a new auditor cannot readily replicate, resulting in various inefficiencies in the new auditor's performance of the audit function. As mentioned above, the rotation requirement could also affect a company's ability to use audit firms to provide non-audit services, by disqualifying audit firms that an audit committee may want to include in the pool of potential successor auditors from providing, or continuing to provide, certain non-audit services to the company. Requiring audit committees and the companies they serve to devote additional resources to these complex transitional issues at a time when many companies are under severe economic stress, and the capacity of audit committees to take on new responsibilities is strained, seems to us imprudent from a governance perspective. Although not all companies might suffer such adverse consequences, it is their audit committee that should make these determinations. Thus, in weighing whether to proceed with a proposal for mandatory firm rotation, the Board should consider carefully the potentially significant impact on corporate governance.

**D. The Board should address its legal authority to require mandatory audit firm rotation.**

Although we understand that the Concept Release reflects the Board's ongoing efforts to explore steps to enhance auditor independence, as well as objectivity and professional skepticism, we believe that before the Board moves forward to propose a mandatory audit firm rotation rule, it needs to consider whether it possesses the legal authority to adopt such a rule.

In enacting the Act, Congress determined to require audit *partner* rotation, but considered and rejected an audit *firm* rotation requirement.<sup>4</sup> As a result, we believe it is an open question whether any action by the Board to impose mandatory audit firm rotation would be consistent

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<sup>3</sup> Cf. *Ohio v. Dept. of Interior*, 880 F.2d 432, 449 (D.C. Cir. 1989) (holding that a rule promulgated by the Department of Interior misconstrued a statute because, in part, "it appear[ed] to be out of sync with the statutory scheme").

<sup>4</sup> See, e.g., Senate Report No. 107-205 (Report of the Committee on Banking, Housing, and Urban Affairs of the United States Senate to accompany S. 2673) (July 3, 2002).

with Congressional intent.<sup>5</sup> The view that Congress intended to reserve to itself the decision as to whether or not to require audit firm rotation is supported by the fact that Congress directed the GAO in the Act to report back to Congress, and not to the SEC or the Board, on the issues associated with mandatory audit firm rotation.<sup>6</sup>

The Concept Release appears to assume that because Congress gave the Board broad authority to establish professional standards for registered public accounting firms in Section 103(a) of the Act, the Board can require mandatory audit firm rotation. However, the Board has stated that the primary purpose of an audit firm rotation requirement would be to enhance auditor independence,<sup>7</sup> and the Release does not address whether such an initiative might be constrained by Section 103(b) of the Act, which directly addresses the Board's standard-setting activities relating to independence. Section 103(b) provides only that "[t]he Board shall establish such rules as may be necessary or appropriate in the public interest or for the protection of investors, to implement, or as authorized under, title II of this Act." Title II of the Act, in turn, merely authorizes the Board to add to the list of prohibited non-audit services included in Section 201 of the Act<sup>8</sup> and to exempt firms and issuers from such restrictions.<sup>9</sup> Accordingly, it is not clear to

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<sup>5</sup> See generally *Food & Drug Admin. v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 125 (2000) (quoting *ETSI Pipeline Project v. Missouri*, 484 U.S. 495, 517 (1988)) (based on a finding of congressional intent to reserve the power to regulate tobacco for Congress itself, the Court held that the U.S. Food and Drug Administration did not have the authority to regulate tobacco products because an agency "may not exercise its authority 'in a manner that is inconsistent with the administrative structure that Congress enacted into law.'"); Norman J. Singer and J.D. Shambie Singer, *Statutes and Statutory Construction* § 65:1 (7<sup>th</sup> ed. 2008) (stating that "government functionaries are entitled to exercise only such powers as are conferred on them, expressly or impliedly, by law.") (citations omitted).

<sup>6</sup> Congress also recently evinced skepticism about the concept of mandatory audit firm rotation in passing the JOBS Act. See Section 104 of the Jumpstart Our Business Startups Act of 2013 (exempting emerging growth companies from any rule adopted by the PCAOB to require mandatory audit firm rotation).

<sup>7</sup> See, e.g., Concept Release at 9 (stating that "a rotation requirement would aim directly at the basic conflict that, while inherent in the Securities Act of 1933, too often proves difficult for auditors to overcome" and that mandatory audit firm rotation might "significantly enhance the auditor's ability to serve as an independent gatekeeper."); Concept Release at 9 (stating that "[a]lthough this concept release is issued in the context of a broad-based conversation on how auditor independence, objectivity and professional skepticism could be enhanced, the Board is most focused on steps it could take under its existing authority to enhance independence, objectivity and professional skepticism.").

<sup>8</sup> Sarbanes-Oxley Act § 201(a) (amending 15 U.S.C. 78j-1(g)(9)).

<sup>9</sup> Sarbanes-Oxley Act § 201(b).

us that an audit firm rotation requirement adopted by the Board would fall within the grant of authority to the Board in Section 103(b). In the event the Board decides to propose a mandatory audit firm rotation requirement, we believe that the Board will need to articulate its legal authority to do so.

**E. The Board should carefully consider and articulate its views regarding the relative costs and benefits of mandatory audit firm rotation.**

We also believe that, were it to determine to propose any mandatory audit firm rotation requirement, the Board should provide in its proposing release evidence sufficient to demonstrate that mandatory audit firm rotation would enhance audit quality, as well as data to demonstrate that the benefits of such a rule would outweigh the potential costs and disruption that would result from such a rule.

When the Board issued the Concept Release, Board Members Daniel L. Goelzer and Jay D. Hanson expressed concerns about the potential costs associated with implementing an audit firm rotation requirement and the need to proceed with caution.<sup>10</sup> Indeed, the Concept Release acknowledges that a rotation requirement “would risk significant costs and disruption”<sup>11</sup> and that “the risk of increasing issuer audit costs may be a consideration that merits particular discussion during a period of economic weakness and heightened global competition.”<sup>12</sup> Although the Board notes the need to be sensitive to such costs, the Concept Release does not include a cost/benefit analysis. Instead, the Board noted that its analysis is currently constrained by a lack of empirical and reliable data and solicited input from interested parties on a variety of subjects relevant to a cost/benefit analysis. We believe that such an analysis of overall costs (including the costs an audit client would incur in order for a successor audit firm to review the prior auditor’s work papers and to gain familiarity with a new audit client’s business and operations) is necessary, and should consider the potential impact of such a requirement on public companies, especially smaller reporting companies and those with specialized audit needs. We believe the Board should be especially careful, in the current economic environment, to avoid imposing costs on companies that will not achieve a commensurate benefit to a company’s security holders.

The July 22, 2011 decision of the U.S. Court of Appeals for the District of Columbia Circuit in *Business Roundtable and Chamber of Commerce of the United States v. Securities and*

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<sup>10</sup> See Daniel L. Goelzer, Remarks at PCAOB Open Board Meeting (Aug. 16, 2011) (“I have serious doubts that mandatory rotation is a practical or cost-effective way of strengthening independence.”); Jay D. Hanson, Remarks at PCAOB Open Board Meeting (Aug. 16, 2011) (“I believe we should proceed cautiously down this path.”).

<sup>11</sup> Concept Release at 3.

<sup>12</sup> Concept Release at 2.

*Exchange Commission*<sup>13</sup> also underscores that the Board should be mindful of the need to conduct a full and diligent review of the costs associated with its rules and regulations prior to adoption. In *Business Roundtable*, the court invalidated the SEC's "proxy access" rule. The court did so on the grounds that the SEC had failed to properly consider and disclose the economic implications of the rule to companies, as required by Section 3(f) of the Exchange Act. Although the Board itself may not be subject to the same statutory requirements as the SEC, we believe the SEC would be subject to those requirements in connection with approval of any audit firm rotation rule adopted by the PCAOB. We therefore believe that any determination by the Board to propose audit firm rotation requirements should be accompanied by compelling empirical data, and that the Board should be transparent with respect to its analysis and its conclusions regarding the potential costs and expected benefits of mandatory audit firm rotation.<sup>14</sup>

Similarly, we urge the Board, if it decides to propose a mandatory audit firm rotation requirement, to provide clear and objective support for its belief that audit firm rotation would enhance auditor independence or audit quality. As noted in the Concept Release, audit quality

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<sup>13</sup> 647 F.3d 1144 (D.C. Cir. 2011) available at [http://www.cadc.uscourts.gov/internet/opinions.nsf/89BE4D084BA5EBDA852578D5004FB8BE/\\$file/10-1305-1320103.pdf](http://www.cadc.uscourts.gov/internet/opinions.nsf/89BE4D084BA5EBDA852578D5004FB8BE/$file/10-1305-1320103.pdf).

<sup>14</sup> Such transparency is critical, particularly because the costs associated with implementing mandatory audit firm rotation could be significant. A 2003 GAO report on the potential effects of mandatory audit firm rotation, mandated by Section 207 of the Act, notes that the larger accounting firms estimated that a rotation requirement would increase audit costs in the initial year of an engagement by approximately 20 percent. See U.S. Gen. Accounting Office, GAO-04-216, *Public Accounting Firms: Required Study on the Potential Effects of Mandatory Audit Firm Rotation* 8 (2003). The Concept Release neither confirms nor refutes this estimate. Moreover, it does not purport to evaluate (1) the anticipated increase in direct audit costs, (2) the myriad of potential indirect costs, including, for example, costs associated with the impact that mandatory rotation would have on registrants' financial reporting staffs or the continued ability of firms to provide non-audit services to public companies, (3) the impact on competition between public accounting firms, or (4) the potential market disruption, including consequences to capital formation. We recognize that assessing the economic impact of mandatory rotation is a challenging undertaking, and we encourage the Board to engage in a robust analysis in any rulemaking release about the potential costs and market impact that might result if the Board were to impose any such requirement. In this regard, we note that, pursuant to its obligations under Section 19 of the Exchange Act, the Board currently provides the SEC with a summary of the Board's view of the burden on competition when submitting a final rule for Commission approval. It is not clear, however, that this summary would comply with Section 3(f) of the Exchange Act, as interpreted by the D.C. Circuit in *Business Roundtable*, if that section were to apply to the Board.

may actually suffer in the early years of a new engagement, as the new auditor would likely not be as familiar with the client as the prior audit firm, and there may be a limited number of qualified successor audit firms for certain industries and in some countries.<sup>15</sup> The Concept Release does not provide data demonstrating that the lack of auditor independence, objectivity and skepticism is a systemic problem in need of a remedy. In fact, the Board's preliminary analysis of its own inspection data does not show any correlation between auditor tenure and the number of comments in Board inspection reports.<sup>16</sup>

The Board acknowledges in the Concept Release that determining the root causes of audit failures is extremely complex and that it needs to deepen its understanding of those causes. We also recognize the Board's commitment to identifying the sources of audit failures, and believe the Board should consider focusing its efforts on understanding and identifying the root causes before proposing solutions to address them. Among other things, the Board should carefully consider whether, in the context of prior auditing deficiencies, such deficiencies arose due to impaired independence as a result of a long-term relationship with a single audit firm, or instead because of other factors. This effort is particularly important because, depending on the nature of the underlying quality control deficiencies, requiring the rotation of audit firms runs the risk of exacerbating those deficiencies, rather than reducing them.<sup>17</sup> Unless the Board is satisfied that it understands the underlying causes of audit failures, we question whether the Board can make a meaningful assessment of the benefits and drawbacks of mandatory audit firm rotation.

Given these factors, in the event the Board determines to proceed with a proposal to require mandatory audit firm rotation, we urge the Board to conduct and publish a thorough analysis of the potential consequences of implementing such a requirement. This analysis should consider the burdens that would be imposed on companies as a result of an audit firm rotation requirement, relating to cost, audit quality issues and operational issues that companies may be required to face (such as the need to forbear from retaining audit firms to provide non-audit services if such audit firms may in the future be retained as auditors pursuant to the rotation requirement). In addition, the Board should consider the implications of such a rule to certain companies, including smaller reporting companies, companies engaged in specialized industries that use specialized accounting standards, and multinational companies.

Finally, as an alternative to proposing a mandatory audit firm rotation requirement, we believe it would be appropriate for the Board, in coordination with the SEC, to examine the independence issues in greater detail and consider other means to enhance auditor objectivity and

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<sup>15</sup> Concept Release at 11, 13-14.

<sup>16</sup> Concept Release at 16.

<sup>17</sup> See Remarks by Brian T. Croteau, Deputy Chief Accountant, SEC Office of the Chief Accountant, Before the 2011 AICPA National Conference on Current SEC and PCAOB Developments, "The Role of the Audit Performance Feedback Loop in Audit Policy Decision-Making" (Dec. 5, 2011) at 6.



skepticism. For example, one such alternative might be to provide for expanded disclosure, on a periodic basis, about the process undertaken by corporate audit committees to discharge their current responsibilities under Section 301 of the Sarbanes-Oxley Act relating to the appointment, compensation and oversight of the outside auditors.

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The Committees appreciate the opportunity to submit these comments. Members of each of the Committees are available to meet and discuss these matters with the Board and its staff and to respond to any questions.

Very truly yours,

/s/ Jeffrey W. Rubin

Jeffrey W. Rubin

*Chair of the Federal Regulation of  
Securities Committee*

/s/ Michael Scanlon

Michael Scanlon

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and Accounting  
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