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March 12, 2012

Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: March 21, 2012 Public Meeting on Auditor Independence and Audit Firm Rotation

Members of the Board:

I am pleased to submit the attached copy of Deloitte LLP's comment letter on the Board's *Concept Release on Auditor Independence and Audit Firm Rotation* (the Concept Release), to become part of the written record for the public meeting, and I appreciate this opportunity to offer some additional thoughts.

On behalf of Deloitte, I commend the PCAOB and Chairman Doty for emphasizing the importance of auditor independence, objectivity, and professional skepticism. These are core issues for the profession, and the Concept Release has been a catalyst for ideas on improving the performance of the auditor's vital role in serving investors and the capital markets.

ALTERNATIVES TO MANDATORY AUDIT FIRM ROTATION

In reviewing the many comment letters the PCAOB received in response to the Concept Release we note that the great majority did not favor mandatory rotation as a means to enhance auditor independence, objectivity, and professional skepticism. Many, however, suggested more targeted, less risky, and less costly ways to advance these important audit quality attributes.

In our comment letter we offered over a dozen such ideas, designed to build upon the framework created by the Sarbanes-Oxley Act and promote certain best practices. In summary, they were to reinforce the audit committee's responsibility for overseeing the audit firm; expand communications between the audit firm and audit committee; initiate PCAOB actions that would increase understanding of and compliance with expectations regarding auditor independence, objectivity, and professional skepticism; enhance the expertise of audit committees; create audit quality councils to advise audit firms; and conduct further study to provide additional facts and insights.

We observe that the ideas offered by other parties generally paralleled the themes in our suggestions. Three that were not in our letter but which are among the many we would support are audit firm issuance of transparency reports,[1] evaluating the effects of planned new PCAOB audit quality standards,[2] and PCAOB efforts to inform and cooperate with audit committees to enhance overall audit effectiveness.[3]

EXTENDING THE BOARD'S INQUIRY

The responses provide the Board a strong foundation on which to base further examination of ways to enhance auditor independence, objectivity, and professional skepticism. But the Board also has the opportunity to broaden the inquiry to address audit quality as a whole.

We believe broadening the scope would be in the best interest of investors, because, as the Concept Release acknowledges, independence, objectivity, and professional skepticism are not the only determinants of audit quality. And it is overall audit quality that contributes to financial reporting quality, which should be the ultimate goal of any regulatory system that holds investor protection as its mission.

Including a range of stakeholders in the public meetings is a positive first step, but we hope formal public meetings are only a beginning. We recommend that the PCAOB engage with other regulators, investors, boards and audit committees, financial executives, the auditing profession, and others to seek the best result for investors.

REVIEW OF RESEARCH FINDINGS

Our comment letter presented data on a variety of topics pertinent to the inquiry and contained extensive appendices documenting information on research studies, informed opinion, and the status of mandatory rotation policies abroad.

Since December we have continued to monitor developments and track the literature. We have identified some new research reports and other data, which will be noted in an updated comment letter that we will file by the April 22 deadline. The new material does not affect the basis for the comments in our December filing.

* * * * *

As we said in our comment letter, investors are best served when all the interconnected components of the financial reporting system are considered together. We encourage the PCAOB to work with the wide variety of market participants who have demonstrated an interest in this important subject, and we at Deloitte stand ready to continue to work with you in this way.

I thank you for your consideration and look forward to participating in the meeting on March 21. If in the meantime you have any questions or would like to discuss these matters further, please contact me at (212) 492-4508.

On behalf of the partners and people of Deloitte:

Joe Echevarria, CEO
Deloitte LLP

cc: James R. Doty, PCAOB Chairman
Lewis H. Ferguson, PCAOB Member
Jeanette M. Franzel, PCAOB Member
Jay D. Hanson, PCAOB Member
Steven B. Harris, PCAOB Member
Martin F. Baumann, Chief Auditor and Director of Professional Standards

Mary L. Schapiro, SEC Chairman
Luis A. Aguilar, SEC Commissioner
Daniel M. Gallagher, SEC Commissioner
Troy A. Paredes, SEC Commissioner
Elisse B. Walter, SEC Commissioner
James L. Kroeker, SEC Chief Accountant
Brian Croteau, SEC Deputy Chief Accountant

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[1] Versions of this idea were suggested by the Center for Audit Quality, KPMG, and PricewaterhouseCoopers, among others.
[2] Versions of this idea were suggested by the Center for Audit Quality, Ernst & Young, KPMG, and PricewaterhouseCoopers, among others.
[3] Versions of this idea were suggested by Apple, BlackRock, Mike Cook, Ernst & Young, and McGladrey & Pullen, among others.

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December 8, 2011

Mr. J. Gordon Seymour, Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: Request for Public Comment on *Concept Release on Auditor Independence and Audit Firm Rotation,* August 16, 2011 (PCAOB Release No. 2011-006, PCAOB Rulemaking Docket Matter No. 37)

Dear Mr. Seymour:

Deloitte & Touche LLP (Deloitte) is pleased to respond to the request for comments from the Public Company Accounting Oversight Board (PCAOB or the Board) on its August 16, 2011 *Concept Release on Auditor Independence and Audit Firm Rotation* (the Concept Release).

EXECUTIVE SUMMARY

Deloitte agrees that auditor independence, objectivity, and professional skepticism are essential to audit quality, which in turn promotes the effective functioning of capital markets. In response to the Board's invitation to submit comments we undertook a broad, fact-based assessment of the public company disclosure system to explore what steps can and should be taken to better serve the investing public. Our main conclusions:

1. The Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) contains provisions that address concerns about management's influence over auditors, including the potential for an "issuer pays" distortion, by delegating primary responsibility for supervising and compensating auditors to the audit committee, an independent body that represents investor interests.

2. In implementing the Sarbanes-Oxley reforms, best practices have emerged for structuring and conducting interactions among management, the audit committee, and auditors. If certain of these practices were augmented and set as requirements the result would be a more uniform achievement of high standards in areas important to the audit profession's independence, objectivity, and professional skepticism.

3. More uniform achievement of high standards would reinforce favorable trends in financial reporting. For example, there are positive signs in areas such as restatements and securities class-actions filings that include accounting-related allegations.

4. Signs of improvement are not cause for complacency. The context within which public company disclosure occurs is changing. Economic and business conditions are increasingly global, complex, and volatile. Judgments on accounting and auditing matters are becoming more challenging. The Board's call for evaluating the existing system is therefore timely.

5. We have found over a dozen areas in which building upon current best practices would enhance the potential of the Sarbanes-Oxley framework and strengthen public company disclosure. We believe more widespread adoption of the following practices would be especially beneficial:

   - **Audit committee guidance on audit fee negotiation.** Require early and direct guidance from the audit committee in fee negotiations to reinforce the representation of shareholder interests.

   - **Audit firm communication with audit committee prior to earnings release.** Provide that prior to the earnings release the audit firm has sufficient opportunity to review and discuss significant accounting and auditing judgments with the audit committee.

   - **Audit firm discussion of inspection results with audit committee.** Increase the sharing of findings and remediation efforts relating to internal and PCAOB inspections to furnish audit committees with information relevant to their auditor oversight role.

   - **Audit committee report on its oversight of audit firm.** Define an expanded scope for the audit committee report on its auditor oversight and move the report from the proxy statement to the Form 10-K to enhance its timeliness and prominence.

6. We conducted an objective assessment of the literature on mandatory rotation and performed our own research on selected issues. The appendices contain references to the information we collected and reviewed. Our chief findings from this analysis:

   - **Auditor tenure and audit quality.** Research studies show that restatements and frauds are less likely to occur with longer auditor tenure.

   - **Findings from research.** The majority of studies in the literature on mandatory rotation reach an unfavorable conclusion on the balance between costs and benefits.

   - **Implementation impact.** If mandatory rotation were required at the 500 largest U.S. companies, a 10-year phase-in process would entail 50 auditor changes every year compared to the recent average rate of five per year.

   - **Experience abroad.** The economies and capital markets of countries that have adopted mandatory rotation are not directly comparable to those of the United States. Some countries that have adopted the policy have discontinued or curtailed it. Research that is available tends to be unfavorable on the effects of mandatory rotation.

7. The work we have done suggests that building upon the framework created by Sarbanes-Oxley would be more effective than adopting mandatory rotation. However, we are open to additional study that would shed more light on the issues surrounding auditor independence, objectivity, and professional skepticism. We would welcome the opportunity to join the Board, the rest of the audit profession, public companies, directors, investors, and other stakeholders in further pursuing the inquiry the Board has initiated on this subject.

ADOPTING A SYSTEM-WIDE PERSPECTIVE

System for supporting investors and capital markets

The Concept Release appropriately frames the role of the independent audit in the context of the value it provides to users of public companies' financial statements. The independent audit of public company financial statements is just one component of an extensive and interconnected system to protect investors and promote the effective functioning of capital markets. It is therefore important to consider any changes with the entire system in view.

Revisions to the financial segment of the system

Concerns about the causes of the recent financial crisis are being addressed through provisions of the Dodd-Frank Act and the Basel III accord. An implication is that any policy changes involving audits must take into account the amount of adjustment already underway in the financial services sector as banks and other institutions implement the emerging regulatory requirements.

Public company disclosure portion of the system

The public company disclosure portion of the system includes company management, the audit committee of the board of directors, and the audit profession. The system is largely regulated by the Securities and Exchange Commission (SEC), with support from the PCAOB and the Financial Accounting Standards Board.

The public company disclosure system underwent substantial changes with the implementation of Sarbanes-Oxley. A major component of the law was the creation of the PCAOB.

Sarbanes-Oxley also put into place partner rotation requirements to provide audit teams with a fresh perspective on a regular basis. In developing the partner rotation regulations required by Sarbanes-Oxley, the SEC cited the need to strike a balance between a "fresh look" at the engagement and the benefits of maintaining continuity and quality.[1]

Congress made clear in the law that, as representatives of companies' investors, it is independent audit committees and not management that have clear responsibility to select, compensate, and oversee the work of independent outside auditors. The law explicitly states that the audit firm "shall report directly to the audit committee" and thus interposed the audit committee between management and the audit firm. Sarbanes-Oxley also ensured that the audit committee has the resources it needs to execute its duties.

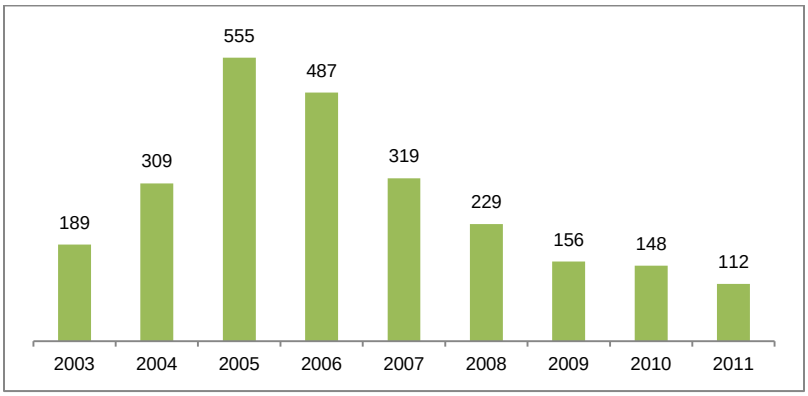
Key indicators show improvements in system performance

In the Concept Release the Board observed that its inspections lead it to believe that audit quality has improved in recent years. Academic research confirms that financial reporting has improved since the adoption of Sarbanes-Oxley.[2] A survey of audit committees conducted by the Center for Audit Quality in 2008 showed that 82 percent of audit committees responding believed that audit quality had improved in the several years prior.[3] Studies of audit committee performance since the passage of Sarbanes-Oxley indicate that strong audit committees contribute to audit quality.[4]

Certain indicators of financial reporting and audit quality also support the conclusion that the public company disclosure system is showing improved performance. For example, a recent analysis covering statistics through October of this year suggests the number of restatements by larger companies will decrease in 2011 for the sixth straight year.[5] Securities class-action filings that included accounting-related allegations have dropped 60 percent since 2002.[6]

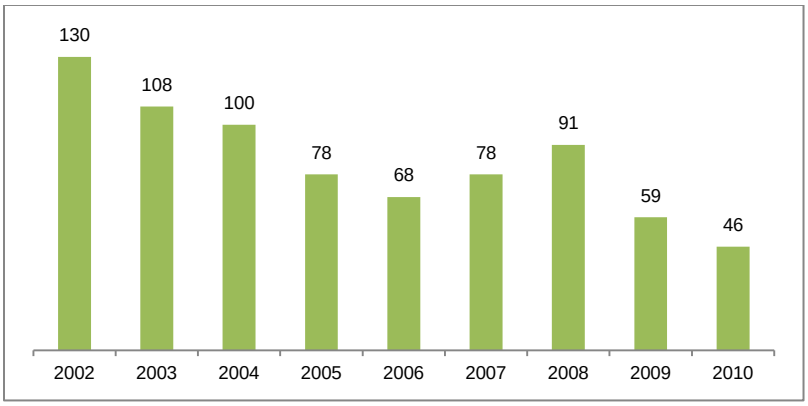
Exhibit 1: Financial statement restatements, 2003-2011

Companies with public float over $75 million; 2011 data through October



Source: Wall Street Journal, Audit Analytics

Exhibit 2: Class action filings including accounting-related allegations, 2002-2010



Source: Cornerstone Research

Our own observations are consistent with the data. In our experience audit professionals consistently make a strong effort to appropriately challenge conclusions reached by a company's management, in the interest of ensuring accurate and transparent financial reporting to investors.

SUGGESTED IMPROVEMENTS TO THE EXISTING SYSTEM

New challenges for public company disclosure

Signs of improving performance do not provide a basis for complacency. The Board followed its observation that audit quality has shown improvement with the statement that, "more can be done to bolster auditors' ability and willingness to resist management pressure." This is a definite imperative. New challenges confront the public company disclosure system, and indeed the entire system for protecting investors and promoting the effective functioning of capital markets.

Globalization and advanced technologies are making the business environment more complex and changeable.[7] Since the recent financial crisis the world has experienced new levels of capital market volatility, political uncertainty, and economic turbulence.[8] Accounting and auditing standards are evolving. Financial statements are increasingly complex and entail growing reliance on management judgments.[9]

Other factors could be added to the list, including shortened Form 10-K filing deadlines combined with significantly enhanced audit documentation requirements, and increasingly sophisticated business models.

Consequently it is important to examine the public company disclosure system to see whether it can be strengthened in the face of new pressures. The Board's solicitation of comments on ways to enhance auditor independence, objectivity, and professional skepticism is a timely call to make a careful assessment of the mechanisms that help maintain investor confidence.

Building on the Sarbanes-Oxley framework

Our analysis of the current system has identified potential improvements the Board should consider. Generally these involve augmenting and expanding practices that have been adopted within the Sarbanes-Oxley policy environment. The practices are in use at many companies but are not universal. If they were to be required, and in some cases strengthened, the result would be greater uniformity across the system at a higher level of performance. Similarly, there are areas where building on existing regulatory policies and approaches would be beneficial.

These suggested improvements are not exhaustive with respect to improving audit quality. The challenges to audit quality are varied, and are both internal and external to the audit profession. We agree that auditor independence, objectivity, and professional skepticism are bedrocks of audit quality, however, and have therefore focused our recommendations on those specific aspects of audit quality, as requested in the Concept Release.

We note that the Concept Release expresses a preference for ideas that are within the PCAOB's authority. For the reasons discussed above, we believe that investors are best served when the system is viewed as a whole and that changes are made where they will be the most effective without adding unnecessary costs. Thus, we have not limited our discussion to ideas within the PCAOB's authority, although many would require PCAOB action.

Audit firm relationship with audit committee

As noted above, a fundamental precept of the Sarbanes-Oxley policy framework is that the audit committee represents shareholders in selecting, compensating, and overseeing the auditor. The first set of suggested improvements would underscore the primacy of the audit committee in managing the company's relationship with the auditor, independent from management. The ideas all entail augmenting and formalizing practices that are in use at many companies:

1. **Audit committee reviews firms seeking appointment as auditor.** The direct reporting relationship between the audit firm and the audit committee should be emphasized from the outset by ensuring that, when a change in auditors is under consideration, the audit committee plays a prominent role in the process. This could be achieved by requiring that audit committees meet with candidate audit firms without prior review of the firms by management. Additionally, the audit committee could be designated as the recipient of proposals from audit firms seeking to replace the current auditor, with a copy furnished to management.

2. **Audit committee provides guidance on audit fee negotiation.** Congress recognized the "issuer pays" concern; in Sarbanes-Oxley it required that the audit committee be responsible for compensating the outside auditor, and for the pre-approval of services. This arrangement should be supported by a requirement that audit fee negotiation not occur except with early and direct audit committee guidance. Formalizing this protocol would ensure that investors, through the independent audit committee, have a "seat at the table" during the process of determining the fees to be paid to the auditor.

3. **Successor audit partner meets with audit committee.** When a new partner is assigned to replace one whose rotation term has expired, the audit firm should be required to discuss the partner's qualifications with the audit committee directly before any candidates are reviewed by management. A universal requirement to engage with the audit committee on this issue would emphasize the reporting relationship between the audit committee and the outside auditor, help the audit committee understand the partner's appropriateness for the engagement, and establish the relationship between the audit committee and the partner.

4. **Audit committee provides auditor oversight information to investors.** Audit committees are required to report certain activities related to their oversight of outside auditors in the company's annual proxy statement. Defining an expanded scope for the audit committee report would more completely inform investors about the audit committee's role and performance and provide comparable information across companies. The committee's efforts relating to auditor independence, objectivity, and professional skepticism are among the topics on which discussion should be expanded. Additionally, the audit committee report should be moved from the proxy statement to the Form 10-K to enhance its timeliness and prominence.

Audit firm communications

Ensuring regular and substantive communications between the audit firm and the audit committee promotes auditor independence. This should be encouraged by augmenting and requiring certain practices now widely but not universally in use. The first involves the scope of interactions between auditors and audit committees; the other three have to do with the content of the audit firm's communications:

1. **Audit firm communicates with audit committee prior to earnings release.** Timely discussion of significant accounting and auditing judgments by the audit firm with the audit committee avoids situations in which time pressures constrain the exercise of appropriate objectivity and skepticism. The audit firm and audit committee provide more of a check on management when they are able discuss well in advance of financial reporting deadlines the status of sensitive transactions and judgments, including positive and negative information considered, taking into account the views of management and the audit firm.

2. **Audit firm discusses inspection results with audit committee.** Audit committees say they value information on inspections and remediation efforts because such information provides insights relevant to their oversight generally and in particular to their auditor reappointment decisions. There is interest in internal and PCAOB inspections of their particular audit. The same is true of timely PCAOB observations on the current reporting year, such as would be included in a 4010 report on an audit season. Moreover, audit committees express a strong desire to better understand information in Part II of the PCAOB's inspection reports. It would be useful for the

PCAOB and the audit profession to review the protocols relating to the disclosure of inspection results to facilitate discussions on this subject between audit firms and audit committees.

3. **Key members of audit team meet regularly with audit committee.** A practice that supports effective auditor oversight is direct contact between the audit committee and key members of the audit team – including subject matter experts, industry experts, other specialists, and the engagement quality review partner. This provides the committee with a deeper understanding of the issues the audit firm encounters during the audit, as well as the thoroughness and independence with which the firm has performed.

4. **Audit team informs audit committee of national office consultations.** Informing audit committees on a timely basis of significant consultations with the audit firm's national office on auditing and accounting issues helps the audit committee understand how and why certain conclusions were reached during the course of the audit. This practice would complement the audit committee's responsibility under Sarbanes-Oxley to oversee the "resolution of disagreements between management and the auditor regarding financial reporting" and can lend support to the outside auditor in discussions with management.

Auditor's evaluation of management estimates

The exercise of sufficient professional skepticism when evaluating management estimates involving judgments is a crucial element of an effective audit, and a matter that is raised in PCAOB inspection findings. Auditing guidance is provided by AU Section 342, *Auditing Accounting Estimates*, and audit firms have prepared frameworks for reviewing estimates. Given the importance of this area, it would be beneficial if the PCAOB were to take a new step and work with the SEC to implement a judgment framework for evaluating the reasonableness of management's estimates. This would be consistent with a recommendation of the SEC's Advisory Committee on Improvements to Financial Reporting.[10]

PCAOB regulation

We have several suggestions regarding the PCAOB's performance of its regulatory duties that we believe would contribute to enhanced auditor independence, objectivity, and professional skepticism while promoting improved audit quality in general:

1. **PCAOB offers timely consultation on difficult auditing judgments.** The SEC encourages companies and their auditors to seek the SEC's advice on "accounting, financial reporting, and auditing concerns or questions, especially those involving unusual, complex, or innovative transactions for which no clear authoritative guidance exists."[11] SEC consultations can be made formally in writing or informally by telephone, including on a no-names basis. The SEC also publishes many of its telephone interpretations. The audit profession would find it very helpful were the PCAOB to adopt a similar practice to allow for "pre-opinion" consultation on difficult auditing matters.

2. **PCAOB inspector meets with audit committee chair.** As noted above, audit committees are interested in obtaining more information when the PCAOB performs an inspection of an audit of the companies they oversee. The PCAOB should consider making it standard practice for the lead inspector to meet with the audit committee chair when commencing the inspection. The inspector could likewise meet with the chair after the inspection is concluded, once the findings have been provided to the auditor.

3. **PCAOB offers fellowships.** The SEC's Professional Accounting Fellow program is highly valued both by the SEC and the accounting profession. Through the program the SEC benefits from the Fellows' experience with public companies, and Fellows who return to public accounting positively affect the tone at the top of the firms, raising the overall level of performance of the public company audit process. The audit profession would benefit from a similar PCAOB fellowship program by gaining additional understanding of the regulator's perspective on independence and other matters.

Enhancement of expertise

The formation of audit quality advisory councils would furnish audit firms with added perspective on independence, objectivity, and professional skepticism. Increasing the level of audit expertise on audit committees would bolster the ability of committees to oversee auditors and the audit process.

1. **Audit firms form audit quality advisory councils.** In its 2008 Report, the U.S. Treasury Advisory Committee on the Auditing Profession said that firms forming advisory councils made up of independent outside advisers could "improve investor protection through enhanced audit quality and firm transparency."[12] The formation of an audit quality advisory council for each major firm, with a clear charter to focus on audit quality, would provide a means through which audit firms would receive advice and perspective on a potentially wide range of issues related to audit quality, including auditor independence, objectivity, and professional skepticism.

2. **Audit committees gain additional audit expertise.** The Sarbanes-Oxley requirement to disclose whether at least one member of the audit committee is a "financial expert" has served to strengthen audit committees and resulted in greatly improved dialogue between auditors and audit committees. The current definition, however, allows audit committee members to qualify as "financial experts" even if they have limited or no direct auditing expertise. Given the increasing complexity and interconnected nature of accounting, auditing, and financial reporting systems, even since the passage of Sarbanes-Oxley, it is appropriate to explore whether augmenting the audit committee's specific auditing expertise would benefit investors. This could be accomplished by requiring that at least one member of the audit committee be an "auditing expert" or by expanding the definition of "financial expert" to include experience overseeing an external audit. Audit committees could also supplement their auditing expertise by using powers granted under Sarbanes-Oxley to engage outside advisors.

ANALYSIS OF MANDATORY ROTATION OPTION

Our fact-based review of mandatory rotation

As the Concept Release notes, mandatory auditor rotation has been discussed over many decades, but never adopted in the United States. In its 2003 study the Government Accountability Office (GAO) chose not to recommend mandatory rotation after extensive study, but left open the possibility of considering mandatory rotation among other policies if the Sarbanes-Oxley reforms were deemed not effective.[13] In preparing our response to the Concept Release, we undertook our own review of the pros and cons of a mandatory rotation regime, looking at academic literature, other countries' experience, and both our own and others' data. The two appendices document the information we evaluated.

We sought answers to five questions: (1) What is the relationship between auditor tenure and audit quality? (2) How could mandatory rotation affect audit quality? (3) How might mandatory rotation

affect the functioning of the public company disclosure system? (4) What does experience abroad imply for the United States? (5) Could a limited form of mandatory rotation be a workable option?

The results of the review are set out below. In summary, research indicates that mandatory rotation would not be as effective as measures such as those we highlighted above. Abroad, experience with mandatory rotation is mainly limited to smaller countries with economies that are not comparable to that of the United States. Research that has been done on mandatory rotation in other countries tends to show costs outweigh benefits.

What is the relationship between auditor tenure and audit quality?

A key premise underlying the case for mandatory rotation is the proposition that long auditor tenure fosters "coziness" between the audit firm and company management that dulls the audit team's independence, objectivity, and professional skepticism.

The hypothesis is that audit quality problems are correlated with extended auditor tenure. However, our review of the literature found evidence that, if audit quality problems do occur, they are less likely later in the auditor's term. This is consistent with the observation that a deep understanding of the specific business being audited takes time to accumulate.

A 2004 study by professors Joseph Carcello and Albert Nagy is indicative of the findings in the literature. They examined the relationship between audit firm tenure and financial reporting fraud, and found that fraud is more likely to occur in the first three years of the auditor-client relationship.[14]

Other academic research similarly finds that risks to audit quality occur more frequently during the first or second year of an engagement.[15] Examination of financial reporting data supports these conclusions. Studies of fraud at public companies tend to show a correlation to changes in auditors.[16] Research indicates the likelihood of a restatement diminishes as auditor tenure increases.[17]

Additionally, a recent analysis of the Russell 1,000 companies performed by Audit Analytics revealed no instances in which a new auditor discovered problems within one year of the auditor change and initiated an annual restatement of financial statements audited by the prior auditor.[18]

Our own experience bears out the research findings and conclusions. PCAOB inspections of Deloitte audits tend to show a higher rate of adverse Part I findings during the first 10 years of an audit engagement, compared to rates for engagements where tenure is greater than 10 years.

The Concept Release raises the question of whether correlations that relate to voluntary, rather than mandatory, changes in auditors are pertinent. There is evidence that the same pattern holds true in countries that have implemented mandatory audit firm rotation, Italy being an example.[19]

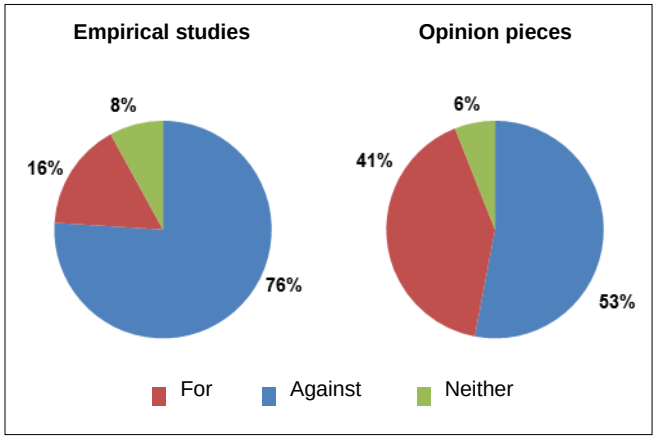
How could mandatory rotation affect audit quality?

The inverse correlation between auditor tenure and audit quality problems implies that shortening average tenure would have negative effects, but proponents of mandatory rotation maintain that a regular change in audit firms is beneficial. We reviewed the literature to evaluate these competing assertions.

We found 66 papers assessing audit firm rotation. Of these, 49 were based on empirical data. Thirty seven or 76 percent generally reached conclusions unfavorable to mandating rotation. Eight of the empirical studies supported mandatory rotation and four did not express a conclusion favoring either

view. The other 17 papers were opinion-based pieces. Of those 17, nine were against mandatory rotation, seven supported it, and one took neither side.[20] Thus for both types of analysis a majority did not favor mandatory rotation, and the proportion against it was higher where the analysis was conducted using empirical data.

Exhibit 3: Papers analyzing mandatory rotation based on data and opinion



Source: Deloitte

In reviewing the papers that analyze mandatory rotation we observed a pattern in the concerns that were cited regarding its adverse effects. Among those that were prominent were: loss of auditor knowledge of the company, difficulty in maintaining auditor industry expertise, audit cost and fee pressures, displacement of audit committee control over auditor choice, and intensified emphasis on marketing.[21]

How might mandatory rotation affect the functioning of the public company disclosure system?
We analyzed two aspects of implementation: (1) phasing in a mandatory rotation policy, and (2) the post-introduction, ongoing effects of mandatory rotation on companies' and audit firms' operations. In both areas we found issues that appear to be inherent and therefore difficult to alleviate.

Phase-in process. Even if the Board were to devise an appropriate method to subject only a subset of companies to mandatory rotation, the phase-in process could require annual auditor turnover on a scale that could exceed the system's resilience:

- **Illustrative phase-in assumptions.** To examine the implications of phasing in mandatory rotation, we adopted the assumption that the policy would apply to only the 500 largest public companies. We also assumed there would be a 10-year rotation period with a multi-year phase-in, a possibility mentioned in the Concept Release.

- **Scale of auditor turnover during phase-in.** Data on the 500 largest public companies show that 10 had an auditor change during the past two years, for an average of five per year. A 10-year schedule for phasing in a new firm rotation requirement would mean 50 rotations per year – 45 more changes or 10 times the recent level.

Incremental costs. To assess the cost implications of a mandatory rotation policy both during phase-in and beyond we assumed that changing auditors would entail a 20 percent increase in costs, consistent with the GAO's estimate in its 2003 report. For the largest 500 companies we calculated an average additional cost of nearly $2 million[22] per audit per year, or an approximate 10-year total effect on the system of almost $1 billion. This added cost would have to be absorbed either by companies, audit firms, or both.[23]

Further, costs could be compounded for some industries. An example is mutual funds, where funds in the same complex often have different fiscal year ends. In these cases the old and new auditor would have to overlap for some period of time, resulting in additional costs without commensurate benefits to fund shareholders, e.g., two firms evaluating management controls.

Audit staff redeployment effects. Among the largest 500 companies, upon rotation both the incoming or outgoing auditor would need to redeploy (or hire or dismiss) about 30 auditors.[24] Using the assumptions above, this would result in the need to manage redeployment of approximately 2,700 auditors (45 x 30 x 2 audit firms) each year, in addition to those resulting from natural turnover of personnel in the firms and from non-mandatory auditor changes. Dislocations of this frequency and magnitude would have detrimental effects on individual careers, the audit profession's ability to attract talent, and the economic stability of local communities.

Limited field of candidates. We analyzed the 500 largest companies by industry sector, region, and audit firm. In some highly specialized sectors, such as aerospace and defense and electric utilities, only two or three audit firms have a significant client base. Moreover, our analysis shows that several sectors have regional outliers – situations in which industry leaders cluster in certain geographic areas but one or two companies are headquartered elsewhere. Examples are banking, insurance, oil and gas, and telecom. This means the incoming audit firm would need to redeploy people with industry experience from other regions, while the industry experts with the outgoing firm might also have to relocate or perhaps move to the incoming firm, which would limit the hoped-for effects of the audit firm change.

Inopportune rotation timing. When companies are subject to a maximum audit tenure rule there is the risk that they will be required to change auditors at a point when doing so will interfere with other corporate priorities, including major transactions. Mergers and acquisitions are an example – we found that among the largest 500 companies, 102, or about 20 percent, had significant M&A activity during the past two years; another 50 percent had some M&A activity. There is also the possibility that the rotation schedule will call for an auditor change when a company is under duress, such as facing bankruptcy or in the midst of a regulatory inquiry. In such situations finding a successor auditor could be particularly difficult.

Cross-border issues. Different national regulations require rotation at different intervals, posing a problem for companies with operations in many countries and subject to different statutory reporting deadlines. In some places there is also the challenge of securing qualified audit firms. SEC registrants located in other countries could be adversely affected for these reasons.

What does experience abroad imply for the United States?

As Appendix 2 illustrates, other countries' experience with mandatory rotation is of limited applicability to the United States. The European Union and India are currently considering versions of this policy, but so far no country with a capital market or economic system comparable to those of the United States requires mandatory rotation.

Currently, only seven of the G-20 countries have some form of mandatory audit rotation. Most are small and/or developing countries. There is little comparability between these countries' economic profiles and that of the United States. Italy is the only large industrialized country among those with a rotation policy. In Italy and other countries with some form of mandatory rotation, such as China, Brazil, and India, economic activity is less market-oriented than in the United States.[25]

There are also countries that adopted mandatory audit firm rotation only to withdraw it. South Korea is one that has repealed its policy entirely. Of the countries that currently require some form or rotation, most require it only of a subset of reporting entities. No consistent regime has developed.

Could a limited form of mandatory rotation be a workable option?

Our research and analyses indicate that mandatory rotation is not as effective as would be making improvements in the existing system. However, a limited form of mandatory rotation – remedial rotation – should be considered. For example, the PCAOB might recommend to the audit committee an auditor change as a result of serious adverse inspection findings that the PCAOB believes cannot be resolved otherwise. In appropriate circumstances, the PCAOB (or the SEC) also could seek agreement from an audit firm to resign from an engagement (or a company to change auditors) as a condition for resolving an enforcement investigation. These measures would allow for change in specific auditor-company relationships, without mandating audit firm rotation for the entire system.

FURTHER STUDY OF AUDIT PROFESSION INDEPENDENCE

The Board's invitation to submit comments has provided an incentive to take a fresh look at the structures and processes that promote auditor independence, objectivity, and professional skepticism. In responding, we have made our exploration of the issues as comprehensive and rigorous as possible. As reported in this letter, our findings indicate that the most effective path would be to strengthen certain aspects of the existing system rather than to require mandatory auditor rotation. The information we considered is set out in the appendices.

Nevertheless, we would support additional inquiry into this subject. There can be no doubt that additional research would shed more light on the issues, and we are open to new insights. Supplying policymakers with the maximum amount of relevant data is in the interest of all.

Moreover, as the Concept Release acknowledges, independence, objectivity, and professional skepticism are not the only determinants of audit quality. Further study would expand the scope of the investigation into the root causes of audit deficiencies, and allow for assessment of the effect of changes in the regulatory system that have not yet been implemented or subjected to a full PCAOB inspection cycle. These include recent PCAOB standards such as the engagement quality review and risk assessment standards, the numerous reforms put into place in the wake of the financial crisis that affect the financial services sector, and significant changes in other industries.

Likewise, it would be productive to conduct research on carefully defined aspects of mandatory rotation experience abroad, since what has occurred in selected countries could be treated as pilot tests, although subject to certain qualifications.

For these reasons we suggest that the Board consider undertaking additional study regarding auditor independence, objectivity, and professional skepticism and related topics. The effort could call upon resources available from organizations representing the audit profession, public companies, boards of directors, investors, and other stakeholders in the public company disclosure system. We believe a

collaborative approach of this type would be particularly useful in further developing the fact base essential for informed decisionmaking in an area of such importance to the American economy.

* * * *

We would welcome an opportunity to further discuss these matters with the Board and the staff. If you have any questions or would like to discuss these matters further, please contact Joe Echevarria, CEO, Deloitte LLP, at (212) 492-4508, or Stephen Van Arsdell, CEO, Deloitte & Touche LLP, at (212) 492-3656. We thank you for your consideration.

Very truly yours,

Deloitte & Touche LLP

Deloitte & Touche LLP

On behalf of the partners and people of Deloitte:

Joe Echevarria

Joe Echevarria, CEO
Deloitte LLP

cc: James R. Doty, PCAOB Chairman
Lewis H. Ferguson, PCAOB Member
Daniel L. Goelzer, PCAOB Member
Jay D. Hanson, PCAOB Member
Steven B. Harris, PCAOB Member
Martin F. Baumann, Chief Auditor and Director of Professional Standards

Mary L. Schapiro, SEC Chairman
Luis A. Aguilar, SEC Commissioner
Daniel M. Gallagher, SEC Commissioner
Troy A. Paredes, SEC Commissioner
Elisse B. Walter, SEC Commissioner
James L. Kroeker, SEC Chief Accountant
Brian Croteau, SEC Deputy Chief Accountant

ENDNOTES

[1] Securities and Exchange Commission Final Rule: *Strengthening the Commission's Requirements Regarding Auditor Independence*, Release No. 34-47265, FR-68 (Jan. 28, 2004) ("The judgment about who should be subject to rotation and how long the partner(s) should remain on the engagement prior to rotating involves balancing the need to bring a "fresh look" to the audit engagement with the need to maintain continuity and audit quality). *See also*, R. Hatfield, S. Jackson & S. Vandervelde, *The Effects of Auditor Rotation and Client Pressure on Proposed Audit Adjustments* (Working Paper Oct. 2007) (suggesting that audit partner rotation may produce many benefits of audit firm rotation without the attendant costs).

[2] *See, e.g.*, G. Lobo & J. Zhou, *Did Conservatism in Financial Reporting Increase after the Sarbanes-Oxley Act? Initial Evidence*, 20 ACCOUNTING HORIZONS 57 (Mar. 2006); R. Ang, *Sarbanes Oxley Effectiveness on the Earning Management* (Mar. 2011).

[3] The Center for Audit Quality, *Report on the Survey of Audit Committee Members* (Mar. 2008) available at http://www.thecaq.org/newsroom/pdfs/auditsurvey.pdf.

[4] *See, e.g.*, K. Hertz-Rupley, E. Almer & D. Philbrick, *Audit Committee Effectiveness: Perceptions of Public Company Audit Committee Members Post-SOX* (draft Feb. 2011) (showing a lower level of restatements when audit committee expertise is present, and that strong audit committees contribute to audit quality).

[5] Maxwell Murphy, *The Big Number: 5*, THE WALL STREET JOURNAL CFO JOURNAL (Nov. 29, 2011), based on Audit Analytics update of 2010 statistics. *See also* Audit Analytics, *2010 Restatements: A Ten Year Comparison* (May 2011) and Audit Analytics, *Audit Tenure, Financial Officer Turnover and Financial Reporting Trends-Russell 3000* (2011).

[6] Cornerstone Research, *Securities Class Action Filings: 2010 Year in Review* (Jan. 2011).

[7] John Hagel III, John Seely Brown, and Duleesha Kulasooriya, *The 2011 Shift Index: Measuring the Forces of Long-Term Change*, Deloitte Center for the Edge (2011), available at www.deloitte.com/shiftindex

[8] Louise Story and Graham Bowley, *Market Swings are Becoming the New Standard*, THE NEW YORK TIMES (Sep. 11, 2011); Sushil Wadhwani and Michael Dicks, *Shorter Risk Cycles Are the New Paradigm*, FINANCIAL TIMES (Nov. 29, 2011)

[9] *Statement on Concept Release on Auditor Independence and Audit Firm Rotation* by Lewis H. Ferguson, Board Member (Aug. 16, 2011).

[10] *Final Report of the Advisory Committee on Improvements to Financial Reporting to the U.S. Securities and Exchange Commission* (Aug. 1, 2008).

[11] *See Guidance for Consulting with the Office of the Chief Accountant* available at: http://www.sec.gov/info/accountants/ocasubguidance.htm.

[12] *Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury* (Oct. 6, 2008).

[13] United States General Accounting Office (now Government Accountability Office) *Report to the Senate on Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services: Required Study on the Potential Effects of Mandatory Audit Firm Rotation*, GAO-04-216 (Nov. 2003) .

[14] J.V. Carcello & A.L. Nagy, *Audit Firm Tenure and Fraudulent Financial Reporting*. AUDITING: A JOURNAL OF PRACTICE AND THEORY, Vol. 23, Issue 2 (Sept. 2004).

[15] *See, e.g.*, A. Ghosh and D. Moon *Auditor Tenure and Perceptions of Audit Quality*, THE ACCOUNTING REVIEW, Vol. 8, No. 2. (2005); J. Blouin, B. Grein, & B. Rountree, *An Analysis of Forced Auditor Change: The Case of Former Arthur Andersen Clients*, THE ACCOUNTING REVIEW, Vol. 82, No. 3 (May 2007).

[16] *See, e.g.*, COSO, *Fraudulent Financial Reporting: 1998-2007: An Analysis of U.S. Public Companies* (2010) (showing that 26 percent of companies at which fraud had occurred changed auditors between their last legitimate financial statement and their last fraudulent financial statement, while only 12 percent of non-fraud companies changed auditors).

[17] J. Stanley & F. DeZoort, *Audit Firm Tenure and Financial Restatements: An Analysis of Industry Specialization and Fee Effects*, JOURNAL OF ACCOUNTING AND PUBLIC POLICY (Mar. 2007).

[18] *See* Audit Analytics Research Briefing: "New Eyes" Restatements Identified in First Audit Year after an Auditor Change (Oct. 17, 2011).

[19] M. Cameran, A Prencipe & M Trombetta, *Auditor Tenure and Auditor Change: Does Mandatory Auditor Rotation Really Improve Audit Quality?* (Working Paper, 2008) available at http://www.fdewb.unimaas.nl/ISAR2009/02_24_Cameran_Prencipe_Trombetta.pdf

[20] The literature included in this count is included in Appendix 1. Our findings are consistent with those of a study of literature done by M. Cameran, D. Di Vincenzo & E. Merlotti, *The Audit Firm Rotation Rule: A Review of the Literature* (Sept. 20, 2005) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=825404 (showing that 22 of 26 regulator reports, 19 of 25 empirical studies, and five of nine opinion-based studies were against mandatory rotation).

[21] See Appendix 1 and Cameran 2005. See also Srinidhi, *Auditor Tenure and Audit Quality: the Role of the Demand for Unique Client Specific Knowledge*, Working Paper (April 2010). See also: *A Survey of the Impact of Mandatory Rotation Rule on Audit Quality and Audit Pricing in Italy*, SDA Bocconi (2003); *Auditing Your Auditor, CFO Magazine* (Apr. 2010); and Fiolleau, *Engaging Auditors: Field Investigation of a Courtship*, Working Paper (Nov. 2009).

[22] We used audit fees to approximate costs to the system. With average annual audit fees for these companies of approximately $9.8 million, a 20 percent increase in costs would be approximately $2 million per year.

[23] Studies of the mandatory rotation regimes in Italy and South Korea both show higher costs to auditors and companies, including increased audit hours. Specifically, a 2002 by SDA Bocconi shows that companies in Italy reported that they incurred additional time devoted to interactions with the new audit firm. Increased costs for audit firms were on average 15 percent for a new client in a familiar industry and 25 percent or higher for a new client in an unfamiliar industry. *The Impact of Mandatory Audit Rotation on Audit Quality and on Audit Pricing: the Case of Italy*, SDA Bocconi (unpublished, 2002). *See also*, S. Young Kwon, Y. Lim, and R. Simnett, *Mandatory Audit Firm Rotation and Audit Quality: Evidence from the Korean Audit Market* (Nov. 2010), available at http://ssrn.com/abstract=1764343.

[24] This was estimated using the $9.8 million average audit fees we found for these companies, and assuming an average rate per hour of $200, which translates to an average of 50,000 audit hours for each change, or about 30 full-time auditors per rotation, per firm.

[25] Terry Miller & Kim R. Holmes, Heritage Foundation and THE WALL STREET JOURNAL, *2011 Index of Economic Freedom*, (2011); World Economic Forum, *The Global Competitiveness Report, 2011-2012* (2011). The differences in economic profiles that imply the need for care in drawing conclusions from experience abroad are illustrated by the rankings in these reports, both of which include measures of relative market liberalization. In the economic freedom index, the United States ranks nine overall and receives a 70 for financial freedom, a criterion that includes reference to independent auditing; Italy ranks 87 and receives a 60 for financial freedom. In the global competitiveness rankings, the United States is five overall and 22 in financial market development; Italy's rankings are 43 and 97. The differences are greater for countries such as China, Brazil, and India.

APPENDIX 1: RESEARCH SOURCES

In this appendix we list the research sources we consulted in formulating our response to the PCAOB's *Concept Release on Auditor Independence and Audit Firm Rotation.* The brief summaries accompanying each are intended to highlight the principal point for which we used each document in our letter. They are not meant to be a complete synopsis nor capture all the conclusions that could be drawn from each document. The major headings correspond to those in our comment letter. Sources are listed in chronological order within each subsection.

ADOPTING A SYSTEM-WIDE PERSPECTIVE

Partner rotation

Final Rule: Strengthening the Commission's Requirements Regarding Auditor Independence, SEC (2003). The judgment about partner rotation involves balancing the need to bring a "fresh look" to the audit engagement with the need to maintain continuity and audit quality.

Hatfield, *The Effects of Auditor Rotation and Client Pressure on Proposed Audit Adjustments*, Working Paper (2007) Audit partner rotation may produce many benefits of audit firm rotation without the attendant costs.

Earnings management

Lobo, *Did Conservatism in Financial Reporting Increase after the Sarbanes-Oxley Act? Initial Evidence*, Working Paper (2006). Sarbanes-Oxley Act implementation has had favorable effects on earnings quality.

Ang, *Sarbanes Oxley Effectiveness on the Earning Management*, Working Paper (2007). Regulatory intervention through the implementation of the Sarbanes-Oxley Act reduced the practice of earnings management.

Audit committee views of audit quality

Report on the Survey of Audit Committee Members, The Center for Audit Quality (2008). Eighty two percent of audit committees responding believed that audit quality had improved in the several years prior to the survey.

Audit committee effectiveness

Hertz-Rupley, *Audit Committee Effectiveness: Perceptions of Public Company Audit Committee Members post-SOX*, Working Paper (2011). Strong audit committees are associated with a lower level of restatements and increased audit quality.

Restatement and other financial reporting trends

2010 Financial Restatements: A Ten Year Comparison, Audit Analytics (2011). Trend by year from 2001 to 2010; restatements declined steadily after peaking in 2006.

Audit Tenure, Financial Officer Turnover and Financial Reporting Trends-Russell 3000, Audit Analytics (2011). Sarbanes-Oxley 404 disclosure of ineffective controls over financial reporting dropped from 8.2 percent of Russell 1000 companies in 2005 to 0.8 percent in 2010. This article also covers trends in restatements, non-audit fees, CFO and audit committee chair turnover, going concern uncertainties, late filings, securities class actions, and SEC comment letters.

Murphy, *The Big Number: 5*, Wall Street Journal CFO Journal (November 30, 2011). Restatements for the nearly 3,700 companies whose public floats exceed $75 million are on track to decline again for the sixth consecutive year in 2011.

Securities class action trends – accounting allegations

Securities Class Action Filings: 2010 Year in Review, Cornerstone Research (2011). Trend by year from 2002 to 2010; dropped by more than 60 percent since 2002.

SUGGESTED IMPROVEMENTS TO THE EXISTING SYSTEM

Challenges to public company disclosure

Hagel, *The 2011 Shift Index: Measuring the Forces of Long-Term Change*, Deloitte Center for the Edge (2011). Waves of deep and underlying change are operating beneath the visible surfaces of today's events. Leading firms are barely maintaining their previous performance levels, the topple rate is increasing, and competitive intensity for American firms has more than doubled in the past 40 years.

Statement on Concept Release on Auditor Independence and Audit Firm Rotation by Lewis H. Ferguson, Board Member (August 16, 2011). Challenges include rapidly evolving economic and business environments, rapidly evolving accounting standards, complex financial statements that increasingly rely on estimates and therefore increasingly complex management judgments.

Story, *Market Swings are Becoming the New Standard*, New York Times (September 11, 2011). It has become more likely for stock prices to make large swings – on the order of 3 or 4 percent – than it has been in any other time in recent stock market history.

Wadhwani, *Shorter Risk Cycles Are the New Paradigm*, Financial Times (November 29, 2011). Explicit measures of investor sentiment suggest a shortening of the duration of the risk appetite cycle – with the number rising from one every two years during the late-1990s to three per two years since the Great Recession struck.

Evaluation of management estimates

Final Report of the Advisory Committee on Improvements to Financial Reporting to the U.S. Securities and Exchange Commission (August 1, 2008). SEC and PCAOB should adopt policy statements on professional judgment.

Pre-clearance of difficult auditing judgments

Guidance for Consulting with the Office of the Chief Accountant (SEC website). SEC encourages companies and their auditors to seek SEC's advice on "accounting, financial reporting, and auditing concerns or questions, especially those involving unusual, complex, or innovative transactions for which no clear authoritative guidance exists."

Firm audit quality advisory councils

Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury (October 6, 2008). Audit firm advisory councils could improve investor protection through enhanced audit quality and firm transparency.

ANALYSIS OF MANDATORY ROTATION OPTION

Government Accountability Office study

Required Study on the Potential Effects of Mandatory Audit Firm Rotation, GAO (2003). "Mandatory audit firm rotation may not be the most efficient way to enhance auditor independence and audit quality."

Auditor tenure and audit quality

Carcello, *Audit Firm Tenure and Fraudulent Financial Reporting*, Auditing: a Journal of Theory & Practice (September 2004). Fraud is more likely to occur in the first three years of auditor tenure.

Ghosh, *Auditor Tenure and Perceptions of Audit Quality*, Accounting Review (80)2 (2005). Investors believe quality is improved with tenure and that mandatory rotation might impose unintended costs on capital market.

Blouin, *An Analysis of Forced Auditor Change: the Case of Former Arthur Andersen Clients*, Accounting Review (82)3 (2007). Mandatory rotation does not improve financial reporting.

Stanley, *Audit Firm Tenure and Financial Restatements: An Analysis of Industry Specialization and Fee Effects*, Journal of Accounting and Public Policy (March 2007). The likelihood of restatements diminishes as auditor tenure increases.

Fraudulent Financial Reporting: 1998-2007: An Analysis of U.S. Public Companies, COSO (2010). Twenty-six percent of companies at which fraud had occurred changed auditors between their last legitimate financial statement and their last fraudulent financial statement, while only 12 percent of non-fraud companies changed auditors.

"New Eyes" Restatements Identified in First Audit Year after an Auditor Change, Audit Analytics (2011). For Russell 1000 companies switching auditors since 2005, there were no instances in which a new auditor discovered problems within one year of the audit change and initiated an annual restatement of financial statements audited by the prior auditor.

Italy's experience with mandatory rotation

Cameran, *Auditor Tenure and Auditor Change: Does Mandatory Auditor Rotation Really Improve Audit Quality?* Working Paper (2008). Audit quality tends to improve over time; forced rotation concentrates work with largest firms, and leads to higher costs.

Knowledge of the company

Srinidhi, *Auditor Tenure and Audit Quality: the Role of the Demand for Unique Client Specific Knowledge*, Working Paper (April 2010). Company specific knowledge is best obtained through long tenure.

Pressure on audit fees

A Survey of the Impact of Mandatory Rotation Rule on Audit Quality and Audit Pricing in Italy, SDA Bocconi (2003). Current rule has intensified competition and led to reduced audit fees. A minimum fee threshold should be considered that addresses audit timing and quality.

Auditing Your Auditor, CFO Magazine (April 2010). Several examples of large audit fee reductions after rotation.

Emphasis on marketing

Fiolleau, *Engaging Auditors: Field Investigation of a Courtship*, Working Paper (November 2009). Mandatory rotation would lead to perennial courtship of companies by audit firms and weaken their independence.

Impact on audit costs

The Impact of Mandatory Audit Rotation on Audit Quality and on Audit Pricing: the Case of Italy, SDA Bocconi (unpublished, 2002). Companies in Italy reported that they incurred additional time devoted to interactions with the new audit firm. Increased costs for audit firms were on average 15 percent for a new client in a familiar industry and 25 percent or higher for a new client in an unfamiliar industry.

Kwon, *Mandatory Audit Firm Rotation and Audit Quality: Evidence from the Korean Market*, Working Paper (November 2010). Increased cost for audit firms and clients with no measurable effect on quality improvement.

Empirical studies on the subject of mandatory rotation

Empirical studies generally not supportive of mandatory rotation

Of the 49 studies we reviewed that were based on empirical data, 37 or 76 percent reached conclusions that were generally unfavorable to mandatory rotation.

1. Bates, *Auditor-Client Affiliation: the Impact on Materiality*, Journal of Accountancy (153)4 (1982). Mandatory rotation is too expensive; partner rotation is sufficient.

2. St. Pierre, *An Analysis of the Factors Associated with Lawsuits Against Public Accountants*, Accounting Review (April 1984). The number of lawsuits increases with new engagements.

3. *Accounting Firm Consolidation: Selected Large Public Company Views on Audit Fees, Quality, Independence and Choice*, GAO (1993). Most companies retain auditor for more than 10 years; high level of satisfaction with longer tenure.

4. *Public Accounting Firms: Required Study on the Potential Effects of Mandatory Audit Firm Rotation*, GAO (1994). Current requirements for partner rotation, auditor independence are sufficient to achieve intended benefits of mandatory rotation.

5. O'Leary, *Compulsory Rotation of Audit Firms for Public Companies?* Accountancy Ireland (April 1996). The benefits of mandatory rotation are outweighed by the associated costs.

6. Arrunada, *Mandatory Rotation of Company Auditors: A critical examination*, International Review of Law and Economics, (17)1 (1997). The rotation rule increases production costs for auditors and distorts competition.

7. Summer, *Does Mandatory Rotation Enhance Auditor Independence?* Working Paper (1997). Auditors are less independent in short-term engagements.

8. Walker, *Mandatory Auditor Rotation: Arguments and Current Evidence*, Accounting Enquiries (Spring 2001). The rate of audit failure is much lower in long term relationships.

9. Geiger, *Auditor Tenure and Audit Reporting Failures*, Auditing: a Journal of Practice and Theory (March 2002). There are more audit reporting failures in the first years of the auditor-company relationship.

10. Johnson, *Audit-Firm Tenure and the Quality of Financial Reports*, Contemporary Accounting Research (Winter 2002). Short audit firm tenures are associated with lower financial reporting quality.

11. *The Impact of Mandatory Audit Rotation on Audit Quality and on Audit Pricing: the Case of Italy*, SDA Bocconi (un-published, 2002). Mandatory rotation produces perceived independence but entails high costs, higher market concentration.

12. Ruiz-Barbadillo, *Does Auditor Tenure Improve Audit Quality? Mandatory Rotation Versus Long Term Auditing*, EAA Congress (2003). Longer tenure tends to increase probability of qualified opinion.

13. Myers, *Exploring the Term of the Auditor-client Relationship and the Quality of Earnings: A Case for Mandatory Auditor Rotation?* Accounting Review, (78)3 (2003). Longer auditor tenure is associated with lower discretionary accruals.

14. Myers, *Mandatory Auditor Rotation: Evidence from Restatements*, Working Paper (December 2003). Longer auditor tenure is not associated with increased restatement activity or the severity of the restatements.

15. *Required Study on the Potential Effects of Mandatory Audit Firm Rotation*, GAO (2003). Mandatory audit firm rotation may not be the most efficient way to enhance auditor independence and audit quality.

16. *Mandatory Audit Rotation, Audit Quality and Financial Markets Equilibrium: the Italian Case,* SDA Bocconi, (2004). Update of 2002 study shows financial markets view rotation as systemic risk, does not affect liquidity of a security, and more interested in quality of audit than rotation.

17. Naswa, *Auditor Rotation and the Quality of Audits*, CPA Journal (December 2004). Mandatory rotation does not improve audit quality or reduce audit fees.

18. Sinnett, *Are There Good Reasons for Auditor Rotation?* Financial Executive (October 2004). Higher earnings quality is associated with longer auditor tenure.

19. Carcello, *Audit Firm Tenure and Fraudulent Financial Reporting*, Auditing: a Journal of Theory and Practice (September 2004). Fraudulent financial reporting is more likely to occur in the first years of engagements.

20. Engelbrecht, *Did Mandatory Firm Rotation Sour Parmalat*? Accountancy SA (August 2004). In South Africa additional rotation costs would be burdensome; insufficient number of audit firms for rotation.

21. Agrawal, *Corporate Governance Consequences of Accounting Scandals*, Journal of Law and Economics, (48)2 (2005). Significant replacement costs may explain why auditor turnover is rare.

22. Ghosh, *Auditor Tenure and Perceptions of Audit Quality*, Accounting Review (80)2 (2005). Investors believe quality is improved with tenure, and mandatory rotation might impose unintended costs on capital market.

23. Comunale, *Mandatory Auditor Rotation and Retention: Impact on Market Share* Managerial Auditing Journal, (20)3 (2005). Mandatory auditor rotation results in lower audit quality.

24. Cameran, *The Audit Firm Rotation Rule – a Review of the Literature,* Working Paper (September 2005). Of 27 reports by global regulators and representative bodies, 23 conclude against the benefits of mandatory rotation. Of 34 academic studies, 25 do not support mandatory firm rotation.

25. Dallocchio, *Heed the Italian Experience,* Financial Times (February 9, 2005). Highest number of partner suspensions occurred in the first year of the new audit.

26. Blouin, *An Analysis of Forced Auditor Change: the Case of Former Arthur Andersen Clients,* Accounting Review, (82)3 (2007). Mandatory rotation does not improve financial reporting.

27. Hatfield, *The Effects of Auditor Rotation and Client Pressure on Proposed Audit Adjustments,* Working Paper (2007). Audit partner rotation could produce benefits similar to firm rotation without excessive cost.

28. Gunny, *Is Audit Quality Associated with Auditor Tenure, Industry Expertise and Fees?* Working Paper (August 2007). Auditor industry expertise is more important than auditor tenure for mitigating deficiencies.

29. Stanley, *Audit Firm Tenure and Financial Restatements: An Analysis of Industry Specialization and Fee Effects,* Journal of Accounting and Public Policy (March 2007). Restatements decline with longer auditor tenure.

30. Jackson, *Mandatory Audit Firm Rotation and Audit Quality,* Managerial Auditing Journal (July 2007). Audit quality increases with audit firm tenure.

31. Cameran, *Auditor Tenure and Auditor Change: Does Mandatory Auditor Rotation Really Improve Audit Quality?* Working Paper (2008). Audit quality tends to improve over time; forced rotation concentrates work with largest firms and leads to higher costs.

32. Brown, *Auditor Tenure and Client Annual Report Disclosures,* Working Paper (September 2009). Longer tenure leads to more consistent and stable disclosures.

33. Lim, *Does Auditor Tenure Improve Audit Quality? Moderating Effects of Industry Specialization and Fee Dependence,* Working Paper (September 2009). Companies audited by firms with industry specialization have higher audit quality.

34. Ruiz-Barbadillo, *Does Mandatory Audit Firm Rotation Enhance Auditor Independence? Evidence from Spain*, Auditing (May 2009). No evidence that mandatory rotation correlates with likelihood of going concern opinions.

35. Lu, *Does Mandatory Auditor Rotation Improve or Impair Corporate Investment Efficiency?* Working Paper (April 2010). Mandatory rotation impairs corporate investment efficiency for high-performing companies.

36. Srinidhi, *Auditor Tenure and Audit Quality: the Role of the Demand for Unique Client Specific Knowledge*, Working Paper (April 2010). Company-specific knowledge is best obtained through long tenure.

37. Kwon, *Mandatory Audit Firm Rotation and Audit Quality: Evidence from the Korean Market*, Working Paper (November 2010). Increased cost for audit firms and companies with no measurable quality improvement.

Empirical studies generally supportive of mandatory rotation

Of the 49 studies we reviewed that were based on empirical data, eight or 16 percent generally reached conclusions favorable to mandatory rotation.

1. Coopley, *Auditor Tenure, Fixed Fee Contracts, and the Supply of Substandard Single Audits*, Public Budgeting and Finance (September 1993). Probability of receiving a substandard audit increases with the length of the engagement.

2. Vanstraelen, *Impact of Renewable Long-term Audit Mandates on Audit Quality*, European Accounting Review, (9)3 (2000). Long-term auditor client relationship significantly increases the likelihood of an unqualified opinion.

3. Dopuch, *An Experimental Investigation of Retention and Rotation Requirements*, Working Paper (2000). Likelihood that the auditors bias their reports in favor of management decreases with a rotation requirement.

4. Gietman, *Improving Auditor Independence through Selected Mandatory Rotation* International Journal of Auditing (July 2002). In an audit market with few large clients, mandatory rotation increases independence, reduces risk of collusion.

5. Chung, *Selective Mandatory Auditor Rotation and Audit Quality: an Empirical Investigation of Auditor Designation Policy in Korea*, Working Paper (October 2004). Audit quality is improved when the duration of auditor-company relationship is reduced.

6. *Speak No Evil*, Glass Lewis (May 2007). Since 2002, at least 6,543 companies have changed their auditors. With so many changes occurring absent a mandatory-rotation requirement, audit-firm rotation every five to 10 years would be feasible and allow "fresh eyes" approach.

7. Lowensohn, *An Empirical Investigation of Auditor Rotation Requirements*, Working Paper (September 2007). Comparison of governmental audits with and without rotation requirements shows rotation yields higher-quality reports.

8. Bowlin, *The Effects of Auditor Rotation, Professional Skepticism, and Interactions with Managers on Audit Quality*, Working Paper (August 2011). A lack of rotation decreases audit effort, increasing audit failure.

Empirical studies that take no position on mandatory rotation

Of the 49 studies we reviewed that were based on empirical data, four or 8 percent did not reach a conclusion for or against mandatory rotation.

1. Church, *A Model of Mandatory Auditor Rotation*, Working Paper (January 2006). Auditor independence seems improved with mandatory rotation, but net benefit depends on the rotation period, start-up costs, auditor learning.

2. European Commission, *Summary of Responses to the Green Paper* (February 2011). Rotation largely rejected by audit profession. Investors had divergent views. Many public authorities did not support. Some support from academics.

3. Kramer, *Audit Firm Rotation, Audit Firm Tenure and Earnings Conservatism* International Journal of Business & Management (August 2011). Not definitive that longer tenure impedes earnings conservatism.

4. Nagy, *Mandatory Audit Firm Turnover, Financial Reporting Quality, and Client Bargaining Power: the Case of Arthur Andersen*, Accounting Horizons (June 2005). For small companies there is an insignificant relationship between short audit tenure and discretionary accruals.

Opinion-based sources

Opinion-based sources generally not supportive of mandatory rotation

Of the 17 sources we reviewed that were not based on empirical evidence, nine or 53 percent generally did not support mandatory rotation.

1. Hoyle, *Mandatory Rotation is not the Best Solution to the Problems of Independence and Public Protection*, Journal of Accountancy (May 1978) Mandatory rotation increases cost and complexities in organizations.

2. Lennox, *Audit Quality and Auditor Switching: Some Lessons for Policy Makers* Working Paper (1988). Retention of auditor preferable to mandatory rotation to reduce managerial influence in changing auditors.

3. Arrunada, *Audit Quality: Attributes, Private Safeguards and the Role of Regulation*, European Accounting Review, (9)2 (2000). Mandatory rotation too costly as a safeguard for quality.

4. Stefaniak, *Causes and Consequences of Auditor Switching: A Review of the Literature*, Journal of Accounting Literature, vol. 28 (2009). Review of prior studies and research shows mandatory rotation is not cost effective.

5. Carcello, *PCAOB's Doty Thinks Mandatory Auditor Rotation Should Get a Second Look*, Accounting & Compliance Alert (June 2011). Mandatory audit firm rotation is costly and makes managing audit firm business difficult.

6. Rapoport, *US Auditing Board to Study Accounting-Firm Term Limits*, Wall Street Journal (August 17, 2011). May increase skepticism but not most cost effective.

7. Hatfield, *A New Spin for Audit*, Treasury & Risk (September 11, 2011). Little gain moving from mandatory partner rotation to firm rotation.

8. Chasen, *Red Flags on Mandatory Auditor Rotation*, Wall Street Journal CFO Journal (October 19, 2011). Forced rotation denies unique strength auditors have in industry knowledge.

9. Noto, *Term Limits Will Diminish Quality of Multinational Audits*, Wall Street Journal CFO Journal (November 28, 2011). Economy has benefited from a governance system that relies on experienced and knowledgeable independent directors acting in good faith. Mandatory rules will undermine directors' ability to fulfill responsibilities.

Opinion-based sources generally supportive of mandatory rotation

Of the 17 sources we reviewed that were not based on empirical evidence, seven or 41 percent generally supported mandatory rotation.

1. Brody, *Mandatory Auditor Rotation,* National Public Accountant (May 1998). Perception is that an auditor is more independent when there is a shorter relationship with client.

2. Healey, *The Benefits of Mandatory Audit Rotation,* Regulation (2003). Increases investor confidence and auditor independence.

3. Imhoff, *Accounting Quality, Auditing and Corporate Governance,* Accounting Horizons (Supplement 2003). Mandatory rotation would improve quality although auditors can't be blamed for all weak governance.

4. Kaplan, *The Mother of All Conflicts: Auditors and their Clients*, Illinois Public Law and Legal Theory Research (2004). Long term relationships compromise auditor independence.

5. Moore, *Conflicts of Interest and the Case of Auditor Independence,* Working Paper (2005). Mandatory rotation eliminates conflict of interest.

6. Jennings, *Strong Corporate Governance and Audit Firm Rotation,* Accounting Horizons (October 2006). From perspective of a judge experienced in litigating accounting failures, there is less likelihood of fraud if auditors rotate.

7. *Musical Chairs: Auditor Rotation,* The Economist (September 3, 2011). Relationship with auditors too long-standing at most companies and compromises investors.

Opinion-based source that takes no position on mandatory rotation

Of the 17 sources we reviewed that were not based on empirical evidence, one or 6 percent took no position on mandatory rotation.

1. Whitehouse, *PCAOB Rekindles Divisive Auditor Rotation Debate* (Compliance Week, 2011). Different views on mandatory rotation from several businesspeople.

APPENDIX 2: OTHER COUNTRIES' EXPERIENCE WITH AUDIT FIRM ROTATION POLICIES

Note: the information presented is based on a best-efforts research initiative. The information is not represented as exhaustive and has not been independently verified.

Countries that have some form of rotation policy

GDP figures are in $U.S. billion, current prices. For comparison, U.S. GDP is $14,527. GDP data is from IMF World Economic Outlook Database, September 2011

Country	Scope of requirement	GDP
Bolivia	Six-year rotation for financial institutions and listed companies; three-year rotation for insurance and reinsurance companies, and pension funds.	20
Brazil	Five-year rotation for non-bank listed companies, 10-years if the company has a statutory audit committee. To begin in 2012	2,090
China	Five-year rotation for state-owned entities and financial institutions.	5,878
Croatia	Seven-year rotation for banks; four-year rotation for insurance and leasing companies.	61
Ecuador	Five-year rotation for financial institutions; six-year rotation for insurance companies,	58
Iceland	Five-year rotation for financial institutions and insurance companies.	13
India	Four-year rotation for banks and insurance companies; two-year rotation for provident trusts; four or five-year rotation for public sector entities	1,632
Indonesia	Five-year rotation for central bank, six-year rotation for public and private companies. However, many firms "reconstitute" every six years.	707
Israel	Two three-year rotation periods for government companies with possible extension in certain circumstances.	217
Italy	Nine-year rotation for all listed companies and public interest entities.	2,055
Macedonia	Five-year rotation for banks and insurance companies.	9
Morocco	Six-year rotation for all banks; 12-year rotation for listed companies.	91
Oman	Four-year rotation for listed companies, government controlled companies, and private joint stock companies.	58
Pakistan	Five-year rotation for financial institutions and insurance companies.	177
Paraguay	Three-year rotation for financial institutions, insurance and reinsurance companies, and listed companies.	18

Countries that have some form of rotation policy (cont.)

GDP figures are in $U.S. billion, current prices. For comparison, U.S. GDP is $14,527. GDP data is from IMF World Economic Outlook Database, September 2011

Country	Scope of requirement	GDP
Peru	Two-year rotation for government entities.	154
Poland	Five-year rotation for insurance companies	469
Portugal	Eight to nine-year rotation recommended on a "comply or explain" basis for listed companies.	229
Qatar	Five-year mandatory rotation for banks and Qatar shareholding companies, whether listed or not; three-year rotation is a recommended best practice.	127
Saudi Arabia	Five-year rotation for all joint stock listed companies, except for banks, which upon request from the central bank, ensure partner rotation instead	448
Serbia	Five-year rotation for banks; five-year rotation for companies and insurance companies with 10 years allowed when combined with partner rotation.	38
Slovenia	Five-year partner *or* firm rotation recommended for public companies, five-year rotation required for insurance and investment management companies.	48
Tunisia	Two three-year rotation periods for financial sector companies. For all listed and non-listed companies, three three-year rotation periods for firms with fewer than three partners and five three-year rotation periods for firms with more than three partners which have partner rotation.	44
Turkey	Eight-year rotation for banks; seven-year rotation for insurance companies; five-year rotation for energy companies and all listed companies, unless the company and audit firm meet certain criteria, in which case partner rotation is sufficient.	736
Ukraine	Seven-year rotation for banks; five-year rotation for national bank.	138
Uzbekistan	Three-year rotation for all companies that require an audit, which include financial institutions, joint stock companies, insurance companies, and not-for-profit organizations.	39
Venezuela	Three-year rotation for banks - to begin in 2014.	293

Countries that adopted mandatory rotation but repealed it in whole or in part

GDP figures are in $U.S. billion, current prices. For comparison, U.S. GDP is $14,527. GDP data is from IMF World Economic Outlook Database, September 2011

Country	Scope of requirement	GDP
Austria	Required for large, listed companies, banks and insurance companies enacted in 2001 and effective beginning in 2004, repealed in 2004 before implemented.	377
Brazil	Required for banks according to regulations enacted in 1996 and applicable to audits starting in 2001, repealed in 2008; see above for non-bank listed company requirement.	2,090
Canada	Required for banks until 1991.	1,577
Costa Rica	Required in 2005, appealed and rejected in 2006 and 2007, reversed in 2010.	36
South Korea	Adopted in 2003 and effective for listed companies beginning in 2006, repealed in 2009.	1,014
Latvia	Required for banks in 1998, 1999 and 2000, repealed in 2002.	24
Pakistan	Required for all listed companies in 2002, but was reversed in 2003-04; see above for financial institutions and insurance companies.	177
Singapore	Required for domestic banks in 2002. Temporarily suspended in 2008, suspension has not been lifted.	223
Slovak Republic	Required for banks in 1996, repealed in 2000.	87
Spain	Required for listed companies and companies over a designated size in 1988, repealed in 1995.	1,410
Turkey	Required for listed companies in 2009, but repealed in early 2011 in favor of partner rotation for companies and audit firms that meet certain criteria; see above for current requirements.	736

While we have not found explanations for the policy changes in every case, we do have information regarding decisions in some countries. Austria, Brazil, South Korea, and Turkey reportedly reversed their policies in favor of more targeted ways to address concerns, including partner rotation. Brazil temporarily suspended implementation for all listed companies because of the scheduled adoption of International Financial Reporting Standards. This was also said to be a contributing factor in South Korea. Spain reportedly repealed its requirement before it was implemented because of concerns over negative audit quality as well as anticipated costs.

Countries that have considered mandatory rotation but decided against it

Many countries have at one time or another considered but rejected mandatory audit firm rotation for some or all entities. These include Canada, Cyprus, France, and New Zealand. In Canada, the parliamentary committee that rejected mandatory rotation in favor of lead partner rotation stated: "We do not…support a requirement for rotation of the audit firm, since in our view valuable company-specific experience would be lost." (Senate Standing Committee on Banking, Trade and Commerce June 2003 report, *"Navigating Through 'The Perfect Storm': Safeguards to Restore Investor Confidence"*.)