COLORADO PERA®

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Office of the Secretary
Public Company Accounting Oversight Board
1666 K. Street, NW
Washington, DC 20006-2803

Re: Docket 037: Concept Release on Auditor Independence and Audit Firm Rotation

I appreciate the opportunity to participate in the Public Company Accounting Oversight Board's public meeting to discuss auditor independence and auditor firm rotation. I am the Interim Executive Director for the Colorado Public Employees' Retirement Association (Colorado PERA). Colorado PERA provides retirement and other benefits to the employees of more than 500 governmental employers and public entities in the state of Colorado. Our membership is comprised of, but not limited to, state government employees, all school district employees, certain university and college employees, judges, certain local government employees, and state troopers. We are the 21st largest public pension plan in the United States with invested assets of more than $40.2 billion.

I have served as President on the Executive Board for the National Association of Public Pension Attorneys, and I am a member of the Board of Directors for the Council of Institutional Investors (the Council). I also serve on the National Institute on Retirement Security (NIRS) Board Council representative.

The Council is a not-for-profit association of public, corporate, and labor pension funds with combined assets under management exceeding $3 trillion. Colorado PERA is an active member of the Council, and I serve as the chairperson of its Policies Committee (Committee). The Committee is charged with developing and presenting to the Council board—and ultimately the Council membership—best practices for corporate governance and other matters directly relevant to investors.

The Committee is a diverse body, consisting of representatives from six public pension funds, two union pension funds and one corporate pension fund. We have been deliberating on the efficacy of mandatory auditor rotation since the second half of 2011. To date, the Committee has not reached a consensus as to whether mandatory rotation would be an appropriate approach to meaningfully increase auditor independence, professionalism and/or skepticism.

Current Council policy affirms an audit committee's responsibility to hire, oversee and fire external auditors. Our existing policy also calls upon audit committees to seek competitive bids for the audit job at least once every five years.[1]

During our deliberation on auditor independence and rotation, the Council's Policies Committee has considered:

- perspectives from advocates on both sides of the issue both from within the Council's membership and outside of it;
- the percentage of companies in the U.S. that have retained the same auditor for multiple decades;
- the workability of a rotation requirement in an environment with only four major audit firms and the need for sector specialization;
- studies that draw conclusions from auditor changes in a non-mandatory environment;
- general findings from PCAOB audit inspections and impediments to audit committee members' access to the PCAOB's company-specific findings;
- perspectives shared by several highly-regarded participants at the PCAOB's first roundtable event on this topic in Washington, D.C.; and
- regulatory requirements found in overseas markets.

In addition, the Committee has spent some time investigating the claim that rotation may lead to significant increases in audit fees. Our non-scientific review of 85 large-cap U.S. companies that changed their auditor since 2004 found that while the median overall change in audit fees from the two years prior to the change to the two years after the change was an increase of 18 percent, 41 percent of the companies actually saw their audit fees go down.[2]

While mandatory rotation remains on the table, the Committee does not view this to be the *only* alternative. For example, the Committee is considering a policy that would identify circumstances under which auditor independence could be particularly at risk, and strongly urge audit committee members to consider voluntary rotation in those circumstances.

Another possibility under the Committee's consideration is a comply-or-explain model. We continue to deliberate as to whether the explanation would deliver the greatest benefit upon a certain anniversary of *retaining the same auditor*, or upon a certain anniversary of *declining to submit the audit job for a public bid process*.

Yet another possible reform, which the Committee explored for the first time at its most recent meeting, is to call upon auditors to provide more useful information in the auditor's report. Both audit committee members and investors voting to ratify the audit

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[1] Existing Council policies are available at http://www.cii.org/policies.

[2] A detail discussion of the non-scientific review of audit fees has been attached as a supplement to this written statement.

committee's recommendation would likely benefit from having access to more robust disclosure from audit firms. The Council has previously commented that the auditor's report as it currently exists does not fully meet the needs of investors, who are ultimately the primary customers of audited financial reports.[3] Our Committee has begun to consider whether standardized audit quality indicators, developed carefully by the PCAOB, are necessary.

The above is a summary of the Council's Policies Committee deliberations on auditor rotation. The following comments are my own and do not necessarily reflect the views of the Committee or anyone else.

The Board has received numerous comments on the comply-or-explain model. As described above, the Committee has also discussed the possibility of adopting this model into its policy. I urge the Board to seriously consider the comply-or-explain model. I advocate for well-established trigger points to the comply-or-explain such as; the current auditor's tenure, the presence of former audit partners or managers on the company's payroll, and exceeding a threshold for the percentage of total fees attributable to non-audit services.

Under the comply-or-explain model, audit committees choosing to renew the engagement with an existing audit firm should explain in the proxy statement their rational for not rotating auditors despite the existence or occurrence of a triggering event. I would not support boiler plate explanations from the audit committee. The explanation should be fact and circumstance specific and it should describe the audit committee's decision making process with a reasonable level of specificity to inform investors.

There may be additional appropriate triggers that can be developed through a rigorous discussion about comply-or-explain. One trigger that was considered but not favored for various reasons included rotation upon the event of a significant financial restatement. Such a trigger could have a potential chilling effect on corrective action by the existing audit firm. The firm may forego honest skepticism of their own work if they face potential termination when they find information that could result in a restatement. The other consideration is that sometimes there are restatements that are not material enough to warrant a rotation. Where do you draw that line, and is it the same line for all companies? The complexity of defining a *material* restatement as a triggering event leads me to reject the inclusion of that factor as a comply-or-explain trigger.

Other possible reforms that would improve the system are a requirement to have the senior audit partner sign the audit report, allow the audit committees to have increased access to the PCAOB inspection reports, expand auditor disclosure, such as the adoption of a PCAOB rule requiring an Audit Discussion & Analysis section on the proxy statement, and require that companies undertake a full-scale competitive bid process for the selection of the independent auditor and provide greater transparency through disclosure of the range of the competitive bids and the appointment decision.

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[3] See Council remarks at http://www.cii.org/UserFiles/file/resource%20center/correspondence/2012/09-20-12%20-Letter%20to%20IAASB%20Roundtable%20on%20Auditor%20Reporting.pdf.

Many have commented about the need for empirical data. Paul Volcker said at the PCAOB hearings that cost-benefit analyses are not particularly beneficial in policy decisions where cost and benefits are hard to identify and hard to measure. However, we have to determine a way to measure and assess the increase in value of audited financials that would be attributable to mandating auditor rotation. As the Council Policies Committee Chair, I am responsible for leading the investigation into relevant issues. Thus, I consider these matters in light of those investigations and in light of the proxy access ruling by the D.C. Circuit Court of Appeals and the new standards for the cost-benefit analyses to be met in any future case. Such experience leads me to conclude that before we can even consider imposing mandatory auditor rotation we have to deal with assessing cost, developing evidence of increased value or benefit from those costs, and deal with what appears to be a potentially legitimate concern in connection with the limited number of audit firms available, particularly in specialized industries and geographical locations.

I support and urge the Board to consider moving forward with a comply-or-explain regime and the increased transparency steps outlined above, at this time. Further, I urge the Board to undertake the comprehensive development of data relevant to mandated rotation of audit firms.

I applaud the Board for creating the PCAOB Investor Advisory Group (IAG). The IAG was created to provide views and advice to the Board on policy issues that matter and affect investors. I would like to highlight the excellent work that Barbara Roper, Director of Investor Protection, Consumer Federation of America, and Meredith Williams, Executive Director National Council on Teacher Retirement (former Executive Director of Colorado PERA) have done as designated co-chairs of a sub-group identified as the Independence, Objectivity and Professional Skepticism Working Group within the IAG. This Working Group has focused on developing meaningful survey approaches to identify, not only issues relating to auditor independence, objectivity and professional skepticism, but also, solutions to the identified issues from the view-point of "the investor" or "user" of the audited financials. Those steps provide a valuable beginning and model for further development of data relevant to the issues.

I also commend the Board for taking on the major issues and for diligently considering the potential advantages and disadvantages of mandatory auditor rotation.

Sincerely,

Gregory W. Smith
Interim Executive Director
Chief Operating Officer and General Counsel

Review of Audit Fees – Supplement to Gregory Smith's Statement

Council staff investigated the question of whether mandatory rotation of auditors would lead to meaningful changes in costs to issuers.

Our non-scientific inquiry began with a list of companies with market capitalization exceeding $2.5 billion known to have changed auditors since 2004. To help compensate for the likely abnormal volatility in single-year costs near the time of the change, we compared the sum of two years of fees leading up to the change with the sum of two years of fees after the change.

Any instance in which the change was too recent to allow for a "two and two" comparison was excluded. Furthermore, companies experiencing a merger near the time of their change were excluded. This yielded a sample of 85 cases.

In many instances, both the old and the new auditor received compensation in the year of the change. For such 'split' cases, the "two and two" comparison spanned a five-year period with the middle-year excluded.

Findings on Audit Fees only

With respect to audit fees only, we found that companies experiencing a change had a 59 percent chance of seeing their audit fees rise, and that the median change was an 18 percent increase:

	Companies	Median % change in audit fees
Audit fees increased after the change in auditor	50 (59%)	59.4%
Audit fees decreased after the change in auditor	35 (41%)	-22.4%
Total companies / Net overall change	85	18.4%

We noted that if we had excluded the 'split cases' described above, the likelihood of an increase would have slipped from 59 percent to 54 percent, and the median change in audit fees would have declined from an increase of 18 percent to an increase of 4 percent:

	Companies	Median % change in audit fees
Audit fees increased after the change in independent auditor	33 (54%)	43.3%
Audit fees decreased after the change in auditor	28 (46%)	-21.5%
Total companies / Net overall change	61	3.7%

Findings on total fees paid to the auditor

When we considered the *total fees* paid to the auditor, we found a 52 percent likelihood of increase and a median change of 3 percent.

	Companies	Median % change in total fees
Total fees increased after change in auditor	44 (52%)	49.8%
Total cost decreased after change in auditor	41 (48%)	-21.5%
Total companies / Net overall change	85	3.3%

We noted that if we had removed from consideration the 'split' cases as previously described, the likelihood of total fees increasing would have decreased from 52 percent to 48 percent, and the median change in total fees would have changed from an increase of 3 percent to a decrease of 2 percent:

	Companies	Median % change in total fees
Total fees increased after change in auditor	29 (48%)	31.6%
Total cost decreased after change in auditor	32 (52%)	-21.8%
Total companies / Net overall change	61	-1.8%

While we do believe these findings add to the conversation, we emphasize that a different company universe, different methodology and/or the incorporation of additional factors such as inflation or less readily quantifiable costs such as the loss of institutional knowledge may lead to different conclusions.