

November 2011



PCAOB Concept Release on Auditor Independence and Mandatory Firm Rotation

Summary of Ernst & Young LLP views as expressed in our comment letter¹

Background

On 16 August 2011, the Public Company Accounting Oversight Board (PCAOB or the Board) issued its Concept Release on Auditor Independence and Audit Firm Rotation, which seeks comment on possible ways to meet the Board's objectives in the areas of auditor independence, objectivity and skepticism, including the concept of mandatory audit firm rotation. The PCAOB encourages audit committee members, members of financial management and other financial statement users to comment because of the concept release's potentially wide-ranging impact on issuers and auditors. Public comments on the concept release are due by 14 December 2011. Ernst & Young filed its comment letter with the PCAOB on 18 November 2011.² This document highlights the key messages set out in our response.

¹ Related comment letters filed with the PCAOB may be viewed at <http://pcaobus.org/Rules/Rulemaking/Pages/Docket037Comments.aspx>.

² A copy of the Ernst & Young comment letter may be viewed at [http://www.ey.com/Publication/vwLUAssets/PI/EY_Comment_Letter_on_PCAOB_Rulemaking_Docket_Matter/\\$FILE/EYCommentLetter_FirmRotation.pdf](http://www.ey.com/Publication/vwLUAssets/PI/EY_Comment_Letter_on_PCAOB_Rulemaking_Docket_Matter/$FILE/EYCommentLetter_FirmRotation.pdf).

General views

We believe auditor independence, objectivity and professional skepticism are of paramount importance as underpinnings of confidence in the audit profession. Such attributes are central to who we are and what we do. It is therefore essential that we work with the PCAOB to explore actions that would further improve audit quality and better serve the interests of investors. Below we outline ideas other than mandatory firm rotation that we believe will advance our mutual objective in this important area.

We believe audit quality and the application of objectivity and professional skepticism by auditors have improved considerably since the passage of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley or the Act) and the creation of the PCAOB. The requirements of the Act, particularly with regard to the audit committee and the establishment of the PCAOB, have had a significant and positive effect on audit quality:

- ▶ Sarbanes-Oxley strengthened the role of audit committees and made them responsible for oversight of the auditor and the audit process. This improved audit quality by designating the audit committee to serve as an empowered shareholder ally in the room with management and the independent auditor to further protect shareholder interests.
- ▶ The PCAOB inspection process also has contributed to improved audit quality through the identification of engagement deficiencies, necessary training and skill improvement and, when warranted, the need for remediation plans and appropriate changes in a firm's audit methodology.

We believe that alignment should and does exist among independent auditors, independent audit committees, independent audit oversight authorities (such as the PCAOB) and public company shareholders regarding the objectives of a public company audit. For this reason, we support a policy direction designed to further strengthen audit committees, not undermine them. In this regard, we believe it is appropriate to examine the interrelationships of these four parties and determine whether their alignment can be strengthened even further.

We have confidence in the performance of our audit professionals and in the healthy level of skepticism we regularly employ when executing our responsibilities. Challenging the accounting and financial reporting decisions of the companies we audit is a required, and expected, part of the job, and it happens every day in practice.

Ernst & Young proposals for addressing auditor independence, objectivity and professional skepticism

The audit profession and audit committee community should work closely with the PCAOB and, to the extent necessary, the Securities and Exchange Commission (SEC) in considering the matters raised in the concept release. We believe there are certain ideas that should

be further explored to address the Board's objectives and benefit the public interest. In this regard, we advance the following:

1. Greater PCAOB-audit committee interaction

We believe increased dialogue between the PCAOB and audit committees would be in the public interest. To this end, we support:

- ▶ Enhanced interaction between the PCAOB and audit committees on issues related to standard setting and other aspects of audit policy, and, when warranted, related to specific inspection findings.
- ▶ Adoption of a formal practice under which the PCAOB could recommend audit firm rotation to an audit committee in instances where the PCAOB's enforcement process against a firm has demonstrated that professional skepticism or objectivity was significantly lacking in the firm's audit of a particular company.
- ▶ Engagement with private sector groups to highlight and share with audit committees leading practices that might promote auditor skepticism and objectivity.

2. Increased audit committee transparency

We believe consideration should be given to the following to further the alignment between audit committees and shareholders:

- ▶ Enhance audit committee reports included in the company's annual proxy statements to include discussion of the committee's process to evaluate the independent auditor's performance, including the actions it has taken to assess and protect the auditor's application of professional skepticism.
- ▶ Increase transparency and communications to shareholders regarding the audit committee's execution of its responsibilities, including decisions on the appointment, re-appointment or dismissal of auditors.

3. Continued improvements to audit standards and assessment of their impact

The Board's standards are designed to promote independence and skepticism. The most recent examples are the standards the Board issued on engagement quality review and the auditor's risk assessment process. Moreover, the quality control standards are slated to be updated by the Board in the third quarter of 2012, and are expected to address requirements for maintaining independence, exhibiting professional skepticism and monitoring a firm's compliance with auditing standards. We believe that the Board should permit the many recent and planned changes to PCAOB audit standards noted above to take hold and then review audit firm implementation of these standards to assess their effectiveness in making further improvements to audit quality.

4. The root causes of the Board's inspection findings should be further analyzed

We believe it is critically important that the Board continue its efforts to analyze and understand the root causes of common audit deficiencies. To date, the Board's inspection findings have not tied an auditor's tenure to audit quality. We ourselves undertake such an analysis of inspection findings and take appropriate remedial steps.

Ernst & Young views on mandatory audit firm rotation

1. Mandatory firm rotation is not in the investing public's interest

- ▶ We believe mandatory firm rotation is a blunt instrument with negative effects that would harm corporate governance and investor interests. Mandatory firm rotation would negatively affect shareholders by weakening the US corporate governance structure, which recognizes and seeks to enhance the alignment of interests among shareholders, independent audit committees, independent auditors and independent audit oversight authorities in promoting high-quality audits.
- ▶ Of particular concern is that mandatory firm rotation would override the audit committee's knowledge, perspective and statutory responsibility in overseeing the auditor and replace it with a requirement that has not proven to increase audit quality.³
- ▶ Mandatory firm rotation would curb the significant advantage of longer audit firm tenure wherein an audit firm attains in-depth knowledge and understanding of a company over time, as well as an awareness of the company's risks, which can enhance audit quality.
- ▶ The required partner rotation and natural turnover of company personnel keep relationships between audit personnel and the company being audited fresh.

2. Mandatory firm rotation has significant economic costs and audit risks

We are concerned that many who express support for mandatory firm rotation do not appreciate the resource challenges posed by such a model, the resulting impact on the professionals involved, and the long-term negative impact the model would likely have on audit quality. While companies and audit firms obviously can and do manage transitions and new audit client risks, the volume of such transition activity today is significantly less than what would occur under a mandatory rotation model.

- ▶ Due to the learning curve that audit firms face with any new audit, audits can be less efficient at the beginning of an engagement, and present a higher level of audit risk. These factors would increase the cost of the audit process as a whole if audit firms were regularly being rotated.
- ▶ Public companies would face repeated distraction and disruption due to the need to educate the new audit firm about their business and operations.
- ▶ Although audit firms' costs would increase with mandatory firm rotation, audit fees may actually decrease in the short term, due to fee pressure in an environment where every firm must continuously compete to find new companies to audit. Because of the commitment firms make to delivering high-quality audits, the negative return on the investment eventually would either necessitate higher audit fees or threaten the quality of the audit.

- ▶ Mandatory firm rotation would increase the challenges and costs to recruit and retain qualified personnel. It also would make it more difficult to plan and provide career-enhancing assignments by creating significant capacity and utilization uncertainty. This could result in higher turnover of staff and ultimately make the profession significantly less attractive.
- ▶ Another negative effect of mandatory rotation would be the multiple of effort (relative to what we experience today) required of audit personnel in preparing and being involved in substantially more proposals for new audit engagements. The time, effort and resources that would be needed to manage the significantly increased number of new audit pursuits would be a significant challenge, and the adverse effect of such efforts on audit quality could be substantial.
- ▶ These audit efficiency and risk issues would be compounded for complex global companies with operations in multiple countries.

Other options proposed by the PCAOB

We do not believe the public interest would be well-served by mandatory retendering of audits, compulsory joint audits, changing the current payment model or further limiting permissible non-audit services – all of which would remove important decisions from the control of the independent audit committee charged with overseeing the audit relationship for the benefit of shareholders.

We strongly believe that the drawbacks to mandatory retendering are considerable. Some may believe such an approach could be a reasonable alternative to mandatory rotation as a softer and less disruptive option capable of achieving positive results with respect to auditor skepticism. However, mandatory retendering would not only share many of the challenges of mandatory audit firm rotation, but could have even more disadvantages in practice.

Looking ahead

We intend to continually engage with the Board and others to be certain that the audit services we provide remain valuable to the capital markets and the wider public interest, and that we continue to carry out our responsibilities with a high level of independence, objectivity and professional skepticism.

³ "Auditor Tenure and Auditor Change: Does Mandatory Auditor Rotation Really Improve Audit Quality?" Working Paper, Bocconi University and IE Business School, M. Cameran, A. Prencipe, M. Trombetta, 2010 (Bocconi Working Paper); "Mandatory Audit Firm Rotation and Audit Quality: Evidence from the Korean Audit Market," Soo Young Kwon, Youngdeok Lim, and Roger Simnett (19 November 2010).

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