



## Statement of Grant Thornton LLP

PCAOB Roundtable on Auditor Independence and Audit Firm Rotation  
March 21, 2012

### **Introduction**

Auditor independence, objectivity, and skepticism are the foundation for trust in business and are critical to an investor's ability to rely on the auditing profession and their role in the US capital markets and financial reporting system. As such, the continuous enhancement of these elements is an important effort that we support.

We believe that the vast majority of auditors want to do what is right; they undertake their professional responsibilities with great seriousness. However, we also believe that audit firm tenure over a period of many decades can (a) create the perception of impaired objectivity, and (b) in some instances, increase the risk of a reduced level of auditor objectivity. As ours is a profession based on trust, it is important to remain vigilant in our demonstration of that core value. In circumstances of extreme tenure, mandatory audit firm rotation could be a component of a potential solution to this perceived loss of auditor objectivity; although there is no evidence to suggest rotation will improve audit quality, and its potential negative consequences may be significant.

Specifically, adopting mandatory audit firm rotation will have an effect on the overall cost, conduct, and timing of an audit. We believe that the initial years of implementation would result in the most significant challenges, while any improvements in audit quality may not be seen in the short term and, unfortunately, may not result in measureable and directly identifiable progress.

We are also concerned that if not appropriately implemented, mandatory rotation would accelerate the current trend of large audits gravitating to a small group of firms and therefore, absent a change in audit appointment patterns, will further negatively affect audit firm concentration.

We caution the Board not to assume that mandatory audit firm rotation can address all of the audit quality concerns identified in the PCAOB's Concept Release. We suggest that the on-going efforts to improve audit quality, through new standards, drilling down on audit deficiencies, and firm quality control enhancements, continue to play a significant part in informing the final Board decision on whether and how to implement a rotation scheme.

### **Role of the audit committee**

We echo the concerns expressed by certain audit committee members that a mandatory rotation requirement will impact their governance responsibilities and activities. Given the audit committee's current role to appoint, approve all services, compensate, and oversee an audit firm, it is important to consider the likely diminishment of the relevance of the audit

committee's role in the financial reporting process. We are concerned that a direct offshoot of mandatory audit firm rotation could lead to less audit committee interaction at precisely the time when I believe we all agree more interaction is warranted.

### **Issuer pay model**

As we wrestle with the important issues of auditor independence, objectivity, and skepticism, we believe it is important for us to acknowledge that the issuer pay model, where organization's hire and compensate the professionals who audit their financial statements, lies at the very heart of this discussion.

We have concluded, like many before us, that any option that takes the retention and compensation of the auditor out of the hands of responsible professionals – professionals who are in the best position to know the organization, the needs of the entity, and the auditor's skills and competencies – would likely diminish audit quality for that entity significantly and also cause potential harm to its investors.

We call attention to these challenges to stress the importance of effective regulation and oversight as well as the need for a commitment by regulators and the profession to continue to work together to enhance the independence, objectivity, and skepticism of auditors. The model we have today may not be perfect; but it is the best model for the marketplace, and we continue to collaborate to make it better.

### **Conclusion**

In summary:

- We believe audit firm tenure over many decades is one factor that could affect both the perception and the reality of auditor objectivity.
- Mandatory audit firm rotation could remove the perception that tenure is a factor; but without a change in auditor appointment patterns, its implementation could cause unintended consequences.
- There are significant risks that the implementation of mandatory audit firm rotation could cause greater damage than benefit – increased cost, increased concentration, and inefficiency – with no clear improvement in audit quality.

While we acknowledge extreme tenure may be a real or perceived issue, we are not advocating for mandatory audit firm rotation as the sole solution to enhancing auditor independence, objectivity and skepticism. We are advocating for active dialogue and research regarding the drivers of, and detractors from, auditor objectivity, such as the outreach being performed through this roundtable.

Please find as an attachment our comment letter on the Concept Release that addresses these areas in greater detail.



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Re: PCAOB Rulemaking Docket Matter No. 37, *Concept Release on Auditor Independence and Audit Firm Rotation*

Dear Board Members and Staff:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or Board) *Concept Release on Auditor Independence and Audit Firm Rotation*, and we respectfully submit our comments and recommendations thereon. Similar to the Concept Release, the primary focus of our response is on whether mandatory audit firm rotation would enhance auditor objectivity and professional skepticism. We believe that the Concept Release discusses in a fair amount of detail the potential pros and cons of mandatory audit firm rotation and will encourage thoughtful and insightful feedback. Accordingly, we value the Board's outreach on this complex and controversial matter. We believe that such outreach will facilitate the development of viable and high quality standards that are in the best interests of investors.

Objectivity is critical to the auditing profession and is worthy of more robust study, including, but not limited to, the concept of mandatory audit firm rotation as a means to enhance such objectivity. We believe that the vast majority of auditors want to do what is right. We also believe that extreme audit firm tenure creates, at a minimum, the perception of impaired objectivity. In this regard, mandatory audit firm rotation could be a component of a potential solution to this perceived loss of auditor objectivity; although, the potential negative consequences of such rotation may be significant. Unfortunately, empirical data does not exist as to whether mandatory audit firm rotation would be a practicable solution, nor do we believe that such rotation, on its own, would be the end-all solution to meaningfully enhancing audit quality, including professional skepticism and auditor judgment. As noted in the Concept Release, mandatory audit firm rotation would result in many challenges for both preparers and auditors, and changes of this magnitude will require careful evaluation as to the related costs and benefits, as well as any possible unintended consequences. The majority of our letter will address those potential challenges and consequences, including transition and implementation considerations.

We also believe that it will be essential for the Board to collaborate with non-U.S. regulators and standard-setters on this matter and consider the results of research and outreach performed by others, including responses to the European Commission's Green Paper entitled *Audit Policy: Lessons from the Crisis*. As further described herein, because of the potential global impact, coordination with other jurisdictions is critical, even though the objectives upon which such changes are sought within a particular jurisdiction may differ (that is, market concentration versus objectivity). In this regard, we encourage the PCAOB and other regulators around the world to share collaboratively the knowledge they gain in their respective research, deliberations, and comment letter processes.

More specific comments that align with the topics in the Concept Release are provided below.

#### **Mandatory rotation**

As noted previously, we believe that extreme audit firm tenure could affect the perceived loss of auditor objectivity at some point in time. What is unknown, however, is the extent to which objectivity may be affected and the point in time at which this may happen. As with many of the suppositions and consequences discussed in the Concept Release, the timing and potential impact on audit quality that may occur as a result of a long-tenured relationship cannot be reduced to a scientific formula. While many current independence requirements, including those related to partner rotation, partner compensation, and audit committee pre-approval, should significantly minimize the potential effect of audit firm tenure on objectivity, no partner wants to be the one to lose a significant or long-standing relationship. Accordingly, we believe that it is healthy for both the PCAOB and the auditing profession to maintain a continuous improvement mindset, including consideration of possible enhancements to professional standards requirements or components of possible enhancements like mandatory audit firm rotation.

As appropriately recognized in the Concept Release, mandatory rotation could potentially result in both positive and negative influences on the quality of the financial reporting process and on overall audit quality. As the Board is aware, few jurisdictions have established mandatory rotation requirements. Accordingly, its feasibility and practicality is debatable, because the extent of information known about its potential impact is not readily available.

While the potential benefit of mandatory rotation is enhanced auditor objectivity, it will also likely have an effect on the overall cost, conduct, and timing of an audit. We believe that the initial years of implementation would result in the most significant challenges, as described herein, while the potential improvements in audit quality may not be seen in the short term and also may not result in measureable and directly identifiable progress. If not appropriately implemented, mandatory rotation would accelerate the current trend of large audits gravitating to a small group of firms and therefore, absent a change in audit buying patterns, will further negatively affect audit firm concentration.

The Concept Release expresses the Board's concern with respect to an auditor's mindset, particularly in reference to certain inspection findings. We wholeheartedly agree that the auditor's mindset is essential as it relates to challenging management; this is a skill that needs to

be carefully mastered and reinforced at every level within our profession. We believe, however, that some of the inspection related examples described in the Concept Release relate to the auditor's appropriate application of professional skepticism and judgment, which may or may not have been influenced by the auditor's objectivity. We highlight that distinction because professional skepticism and judgment are qualities that can be influenced by factors unrelated to auditor tenure, including the inherent skills, training, and personalities of audit professionals, as well as the oversight mechanisms and tone-from-the top established by audit firms. We should be careful not to assume, therefore, that mandatory audit firm rotation can address all of the concerns identified in the Concept Release. Further, as the Concept Release notes, there are many factors that could contribute to a perceived audit deficiency, including the fact that two seasoned and well-informed professionals may reach different judgments about the sufficiency and appropriateness of audit evidence or even the range of acceptability of a particular accounting estimate.

There are several questions in the Concept Release that focus on the potential effects of mandatory audit firm rotation on audit quality. Overall, we agree that auditor objectivity may be impacted in certain situations; however, as noted above, instituting a mandatory rotation requirement may not fully address the Board's concerns with respect to audit execution. We believe that the Board may need to allow more time to evaluate the effect of other newly instituted requirements, including engagement quality reviews, on audit quality. We also believe that the Board should continue its outreach to other constituents, particularly audit committee members, to assess the impact of a mandatory rotation requirement on their governance responsibilities and activities. Given the audit committee's current role to appoint, approve all services, compensate, and oversee an audit firm, the Board should assess whether audit committees generally believe that mandatory rotation would diminish the relevance of their role in the financial reporting process, possibly resulting in an unintended consequence of less audit committee interaction and audit firm monitoring.

#### Term of engagement

If the Board determines to move forward with a mandatory rotation proposal, we agree that a term that is too long may not achieve the Board's objectives, while a relatively short term could significantly increase costs and disruption and also impose an egregious burden on both issuers and audit firms. Generally, we believe that a term of less than 10 years would prove to be too short, leading to cost increases that are not in line with any perceived improvement in objectivity over such a short period of time. We believe that a 15 year limit would prove to be more practical, provided the Board satisfactorily addresses the implementation and transition challenges, which may or may not be surmountable.

Even with a hypothetical 15 year term, we believe that some needed flexibility will need to be allowed to accommodate potential company disruptions or other extenuating circumstances. For instance, an extension of the audit firm's term could be permitted in certain cases, such as when a major company transaction is expected in the year of transition or when there is a limitation on the choice of firms that possess the necessary skills and expertise. We believe that this would need to be left to the judgment of the audit committee with some parameters and with appropriate transparency to users.

With respect to audit effectiveness and auditor diligence, there is no doubt that a learning curve exists, particularly in the year of transition. This does not mean, however, that auditors will disregard matters of audit quality or be less diligent, even when their term is coming to an end. What needs to be considered is the fact that more time and costs will be incurred to obtain the necessary evidence, particularly in the initial years of the engagement, while also meeting the issuer's filing deadlines. Audit firms face this challenge today, but the issue will become compounded with increased rotation, as potentially 10% of an audit firm's issuer clients may be new each year under a mandatory rotation regime of 10 years, as contemplated in the Concept Release. This challenge is particularly acute at larger multi-national entities, as discussed further below.

#### Tenure protection

In the Concept Release, the Board discusses promoting a "fundamental shift" in the auditor-client relationship. An inherent risk does exist with respect to the auditor's objectivity because, ultimately, the audit firm is being paid by the company being audited. However, we believe that this risk to audit quality is lessened by several professional and regulatory requirements, particularly those previously mentioned, as well as firm quality control systems. One such example is the establishment of the audit committee pre-approval requirements whereby the audit committee, not management, became responsible for the appointment, compensation, and oversight of the auditor's work. Also, PCAOB inspections, regulatory sanctions, and our litigious environment are very strong deterrents to willful misconduct.

We do not believe that mandatory rotation would fundamentally change the audit firm's relationship with management in a way that would address the perceived issuer-pay model conflict. Even with mandatory audit firm rotation, a company can still replace their auditor in any given year, with or without cause. That annual tension could have an impact on objectivity. Accordingly, we believe that tenure protection, combined with a potential mandatory rotation requirement, could strengthen the auditor's objectivity, as the audit committee would be prevented from replacing the auditor *without good cause*. Thus, something on the order of three-to-five years of term (not fee) protection may be an option. We recognize that this concept is both new and comes with a litany of questions that would need to be answered, such as: "What is good cause?" and "What disclosure might be necessary regarding an early termination?" We highlight the concept purely for consideration.

#### Scope of potential requirement

Proponents and opponents both recognize the potential for a significant increase in costs to issuers and audit firms and potential disruption in the financial reporting process. Accordingly, we understand the Board's concerns related to reducing market-wide implementation costs, while also providing benefits for investors. We recognize that rotation occurs naturally in today's business environment and that audit firms are generally equipped to manage such rotation appropriately. However, a requirement imposing a mandatory rotation period for all issuers would likely result in a significant increase in the number of audit firm changes, particularly in the U.S. This could have a notable, negative effect on the financial markets and the profession at large, if such mandatory rotation is not cautiously implemented. For example, many small issuers will likely have a difficult time attracting enough audit firms to propose on

their audit under a mandatory rotation model, either because of the issuer's size or location. Requiring audit firm rotation for these companies could significantly increase the audit fees they intend to pay so as to attract multiple audit firms. We considered a possible model that would require rotation for companies that are large relative to the size of the audit firm; but, such a model would likely, and possibly dramatically, increase the already excessive level of audit firm concentration, as mid-sized companies may migrate to the larger firms to avoid mandatory rotation requirements that would apply to a smaller firm. All of these consequences would be detrimental to the marketplace and the structure of the auditing profession.

Accordingly, the Board should give some consideration to limiting any mandatory rotation requirements based on the size of the issuer. We believe that a carefully-crafted approach would focus the rotation requirements on audits of companies that have the most impact on the market, while also minimizing the potential costs and unintended consequences on the marketplace and the profession at large.

We have concluded that any limitation based on company size should (1) be simple to measure, (2) allow sufficient time to implement once the threshold is crossed, (3) be measured over a period of time in order to avoid unnecessary volatility in the application. For example, the Board could consider establishing a requirement that a company exceeding \$1 billion in market capitalization (public float) for two or more consecutive quarters is limited to a total 15-year relationship with their auditor. A \$1 billion threshold captures up to 96% of the U.S. market capitalization, which may provide adequate protection for the market, without incurring the negative consequences on many smaller companies. A provision could be included that would give a company up to 24 months to appoint a new auditor if their current auditor has been engaged for 14 or more years (thus, allowing for a smooth transition). Further, the Board could provide a mechanism to allow a company to exit the mandatory audit firm rotation requirement if their market capitalization falls below \$1 billion for at least four consecutive quarters. Such a plan, or a derivative of it, could provide stability and predictability, without unnecessarily burdening smaller companies where the benefits to the market of mandatory audit firm rotation may not be worth the cost.

#### Transition and implementation considerations

Specialization in a particular industry is a positive quality within the audit profession that the Board should strive to maintain. It may take several years before audit firms will be able to expand their specialization into other industries, particularly for mid-size to smaller firms. Accordingly, notwithstanding our earlier suggestion that any rotation requirement be limited based on company size, we agree with the Board that consideration needs to be given to the ability to stagger the rotation requirements between issuers of all sizes and industries; that is, the initial implementation cannot be effective immediately for all issuers and their audit firms that will be subject to rotation, particularly if the requirement will apply more broadly. Also, as indicated previously, we believe that an extension of the rotation period should be available in certain circumstances, at the discretion of the audit committee.

As the Board is also aware, independence conflicts may reduce the issuer's choice of audit firms. Although this issue will most likely affect the larger firms due to the breadth of their

networks, we note that the ability to resolve such conflicts would not be limited to those firms. We have noted that the non-audit services rules, particularly the services performed by affiliates and the period of professional engagement, seem most likely to result in conflict issues. As such, should the Board determine to adopt mandatory rotation, we believe that it would be prudent for an audit committee or an audit firm to have the ability to discuss with the U.S. Securities and Exchange Commission (SEC) situations where independence conflicts would likely arise and the related consequences on the issuer's choice of firms. The possibility of providing SEC exemptive relief in certain circumstances should be considered. As stated below, we continue to support the overarching independence principles related to non-audit services. The significance of certain services, however, may be better left to the purview of the audit committee, including the evaluation of potential independence threats and safeguards.

#### Multinational considerations

The Board requested comments as to the unique challenges that rotation would create for audits of multinational companies. This may be one of the most problematic aspects of implementing a mandatory rotation requirement, as there are several facets to this that would seem to require extensive consideration by the Board. First and foremost, we believe that, to the extent possible, jurisdictional alignment of mandatory rotation requirements is critical. It may be arduous for an audit firm to coordinate and comply with different term lengths for a specific audit client; having to possibly comply with the most restrictive of the requirements throughout an international network firm could intensify the amount of costs and disruption, as well as significant pressure on audit quality. However, as we previously indicated, a relatively short audit firm tenure, even if principally considered to achieve jurisdictional alignment, could result in potentially chaotic situations worldwide.

In addition, the coordination of the use of other auditors in a group audit engagement could affect the effectiveness and efficiency of an audit. In this regard, the use of a network and non-network firm, which could be subject to different requirements, may continually change, requiring the auditor of the group financial statements to continually assess the appropriate audit approach, which is whether to assume responsibility or make reference to another (component) auditor. Mandatory rotation would also affect the resource needs and present additional challenges at the component auditor level, similar to, and potentially more severe than for a U.S. group auditor.

#### Predecessor considerations

The Board also questioned whether existing standards related to predecessor and successor auditor communications are sufficient and whether additional communications are required, such as the predecessor auditor providing the successor auditor with a written report outlining audit risks and other important information. For the most part, auditors have a tendency to communicate effectively with each other in accordance with professional standards. Accordingly, we believe that the existing standards are written in the appropriate context, particularly in defining the line between a predecessor and a successor auditor's responsibilities related to their respective audits. We caution the Board with respect to mandating additional communication requirements, as there could be circumstances, such as a pending lawsuit, that may prohibit a predecessor auditor from providing certain information and related access to

workpapers. Any requirements to share information may necessitate the consideration of proprietary information and changes in laws and regulations.

We also believe that the Board should consider the audit committee's financial reporting and auditor oversight responsibilities, including the two-way communication requirements related thereto. There are certain significant matters that are required to be communicated to the audit committee by the company's auditor. Accordingly, the audit committee should be equipped to have an enhanced dialogue to discuss these matters with a successor auditor.

#### Alternatives to mandatory rotation

As noted in the Concept Release and as currently under consideration in other jurisdictions outside the U.S., there are several potential alternatives to mandatory rotation, including mandatory retendering, audit only firms, and further limitations on the performance of non-audit services, to name a few. Our views on these alternatives follow:

- **Mandatory retendering** – We believe that there is some merit in considering measures such as regular tendering with greater transparency around the appointment decision. With respect to such measures, we believe that a “comply or explain” framework should be considered. A “comply or explain” framework would allow audit committees to maintain responsibility for corporate governance, as it would enable audit committees to describe to investors and other constituents the reasons for decisions to retain or change audit firms. A potential hazard to mandatory retendering, however, may be a change in the auditor's mindset with respect to “selling” the audit (or, in the case of mandatory rotation, selling non-audit services subsequent to the audit firm's term) to the audit committee. In this regard, a cooling off period would need to be considered to mitigate this risk. Nevertheless, mandatory retendering may be a potential alternative solution that could be evaluated and analyzed by the Board.
- **Audit only firms** – We do not support audit-only firms; our view is that this limitation would have a significant adverse effect on audit quality, particularly for smaller audit firms. In today's financial reporting environment, it is critical to have persons with specialized skill or knowledge, such as information technology, tax, and valuation, readily available to assist with the audit engagement. Such expertise not only brings a different perspective to the audit engagement but also enhances its effectiveness. Unlike external personnel, in-house personnel share the same quality control policies and practices, including monitoring. Requiring audit firms to obtain the assistance of individuals with specialized skill or knowledge externally would present unique challenges regarding their availability and documentation and the auditor's ability to interact and meet deadlines. There also would be specific considerations related to their independence and objectivity. We do not view this as a viable option for improving audit quality.
- **Limitations on non-audit services** – In recent years, the performance of non-audit services has had a significant amount of valuable attention. We continue to support audit committee pre-approval of these services and the related overarching independence principles. At this time, we believe that those principles should serve as a basis in assessing non-audit services

that are not specifically prohibited. However, as business practices and models continue to change, it may be necessary to revisit the independence requirements. Changes in the non-audit services rules also may be necessary, as indicated above, if the Board were to adopt mandatory rotation so as to manage conflicts.

We recognize that, based on the Board's existing authority, certain alternatives being discussed by the profession are beyond the Board's purview, including potential re-deliberation of SEC independence rules and compensation set by third parties. These are matters that we believe will need to continue to be assessed in the Board's consideration of mandatory rotation.

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Overall, we support the Board's efforts in diligently considering the potential advantages and disadvantages of mandatory audit firm rotation. Although we have provided our comments and views as to the areas for consideration included in the Board's Concept Release, it is unlikely that the unintended consequences can be fully predicted. We reemphasize the need to be cautious in implementing measured changes that focus on the overriding goal of improving the quality of the financial reporting process and related audit execution.

We would be pleased to discuss our letter with you. If you have any questions, please contact Karin A. French, National Managing Partner of Professional Standards, at (312) 602-9160.

Sincerely,

