

Statement of The Honorable Roderick M. Hills
Concerning Auditor Independence
Before the
The Public Company Accounting Oversight Board (PCAOB)

Washington, D.C.

March 22, 2012

AUDITOR INDEPENDENCE

Thank you for this opportunity to comment upon the effort of the Public Company Oversight Board (“PCAOB”) to enhance the independence, objectivity and professional skepticism of external auditors and in particular to express a personal point of view as to whether a decision to require the regular rotation of external auditors would further those objectives.¹

I begin by reflecting on the fact that this May will mark 36 years since my colleagues on the Securities & Exchange Commission authorized me to forcefully ask the Chairman of the New York Stock Exchange to require an independent audit committee as a condition for listing on the Exchange. My letter was prompted by the fact that SEC enforcement actions were in the process of causing over 400 U.S. based companies to disclose that they had made questionable payments to foreign officials.

In that same letter we told the NYSE Chairman that we were also asking the auditing profession for a new standard that “would require auditors to bring any questionable payments” to the attention of independent audit committees and require issuers to maintain new specific internal controls to increase the likelihood that questionable payments would be uncovered by the auditors. I have attached a copy of that letter as Appendix A.

In a real sense that letter began the continuing effort of the Commission, now supported by the PCAOB, to rely on independent audit committees to protect auditor independence.

By the late 1990’s the accounting scandals of Waste Management, Enron and Global Crossing (among others) made it clear that more had to be done to secure the needed independence, objectivity and professional skepticism of auditors. As a result the Sarbanes Oxley Act was passed. There is, I believe, much of what we did in 1976 at the SEC in the DNA of Sarbanes Oxley: a strengthening of the audit committee, an insistence on strong internal controls, and a forceful effort to improve the quality of the external audit.

I recite that history in support of the proposition that as you seek again to enhance the independence of auditors you maintain your focus on what has gone before and, in particular, that you consider what can be done to enhance the effectiveness of the audit committee’s role in protecting that independence.

¹ Much of what follows is taken from my statement concerning auditor independence before the Securities and Exchange Commission in September of 2000, my testimony in the Enron hearings before the United States Senate Committee on Banking, Housing And Urban Affairs in February of 2002, my article “Restoring Faith in the Audit Process” at page 26 of the Spring 2002 issue of Directors & Boards, and my article at page 16 of the Fourth Quarter 2006 issue of Directors & Boards.

Mandatory Rotation of Auditors

For several reasons I strongly oppose the requirement that corporations be required to change their auditors after the passage of a specified number of years. Many have pointed out that it would be expensive to force auditor changes and that the quality of the audit will certainly deteriorate for the first year or two of a new auditors work. I agree. However, first and foremost of the reasons to reject the notion of mandatory rotation is that such a requirement would substantially reduce the authority and the role of audit committees.

In 2003 fifty-seven men and women, leaders from the worlds of accounting, finance, law, academia, investment banking, journalism, nongovernmental organizations, as well as current and former regulatory officials, met to consider the ***“Future of the Accounting Profession.”*** After two days of deliberations the group expressed the following in its consensus report:

“The Sarbanes-Oxley Act . . . does not require issuers to switch auditing firms every few years and allows audit committees to exercise discretion in determining what non-audit services a company may decide to engage its auditors to provide – other than prohibited services, of course. We hail these policies for leaving in the hands of audit committees the power to make these decisions, and believe that is where those decisions belong as audit committee members are the best qualified to make them. For instance, if rotation of auditors was made mandatory, much of the authority of audit committees over auditors would be forfeited.”²

The fact that the audit committee controls the hiring and firing of the external auditor is at the heart of the progress that our corporate governance system has made over the past 36 years. Mandatory rotation, in my firm opinion would, seriously damage that progress.

One more consideration is important. The accounting/auditing profession needs to attract the best and the brightest of our graduates. Their ability to do so is already handicapped by the fact that engagement partners need regularly to rotate out of an assignment. That fact causes a hardship on families that must move from city to city over their professional career. Mandatory rotation of all firms would multiply that hardship many fold.

Enhancing the Independence of the Audit Committee

The key to enhancing the independence of external auditors is to take substantial action to better insure the independence of audit committees.

² *The Future of the Accounting Profession: the 103rd American Assembly, November 13-15, 2003, Columbia University, page 35.*

Instead of reducing the authority, and thereby the responsibility, of audit committees substantial steps can be taken to enhance their independence and to make their responsibilities more specific.

Enhance audit committee independence:

Although the passage of Sarbanes Oxley made a substantial improvement in the quality of audit committee surveillance of the audit process, the manner in which corporate directors are elected and appointed to audit committees has too often compromised the independence of audit committees from management.

A 2006 Report of the Committee for Economic Development (“CED”) on corporate governance highlighted the problem:

“A paradox of corporate stewardship is that, despite the principle that directors represent shareholders in the selection and retention of management, historically most directors have been selected by management.”³

Until management is removed from the selection of candidates for board membership the full independence of audit committee members will always be suspect and will often be compromised. Over the past 43 years I have served on 20 corporate boards and chaired 12 audit committees. I have been involved in what many would call 10 corporate train wrecks, including one nasty proxy fight. In each of those experiences I witnessed directors who found it difficult to challenge the CEO that brought them on the board.

Better by far to have the nominating process controlled by an independent nominating or governance committee. In the words of the aforementioned CED report:

“In our view, the best approach to building high-quality boards is to assign to truly independent nominating committees the responsibility for recommending new board candidates and for evaluating the performance of existing board members. The nominating committee should also have the responsibility of recommending committee assignments.”³

Better also for the board, with management participation, to determine in advance of a board opening, the qualifications they will seek for the opening when it occurs, and to broadcast that description to their shareholders

Audit committees should do more:

³ *Committee for Economic Development: Private Enterprise, Public Trust: The State of Corporate America After Sarbanes-Oxley, 2006, page 4.*

Audit committees should be required to give formal and serious consideration to the replacement of the external auditor at regular intervals of say 5 to 7 years.

If, after due consideration, they decide to retain the existing auditor they should be required to explain the steps they have taken in making that decision. There are seasoned consulting firms that can offer audit committees an evaluation of the efficacy of their existing audit firm and provide a view as to whether the relationship between the auditor and management is satisfactory.

Audit committees could also, on occasion, engage a different auditing firm to perform the audit on a discrete part of the company just to compare the quality of work done by their existing firm.

It should be self-evident that an audit committee that is required to evaluate the performance of the external audit will have a far more beneficial effect on auditor performance than one that has no authority over the retention of the auditor.

A mandatory rotation system would, in short, leave the external auditor without effective oversight.

Other Issues

The audit fee:

Many have argued for years that the independence of the external auditor is necessarily compromised by the fact that management pays the fees. That, of course, should not be an accurate statement. It is now the responsibility of the audit committee to manage the compensation paid to the external auditor.

At the very least audit committees should on occasion seek independent assistance in determining whether the "scope" of the audit that is proposed is appropriate, whether the hours proposed to be spent on the audit are reasonable and whether the quality of personnel assigned to the audit is adequate.

As an audit committee chairman of one company or another over a period of 40 years I have too often witnessed the remarkable coincidence where auditors raised their hourly rate by the same percentage as they reduced the hours they planned to spend on the audit. It is too often the practice of management to tell the audit committee that they have reached a satisfactory agreement with the auditors over the scope of the audit and the amount of the fee.

The PCAOB and/or the SEC should insist that audit committees demonstrate how they are exercising their authority with respect to the payment of audit fees.

The cross selling of services:

The PCAOB has expressed concern about the evidence they continue to find that auditors seek and often receive extra compensation for selling consulting services to audit clients. In a keynote speech last June in Pasadena, California, Chairman Doty emphasized the importance of keeping "auditors singularly focused on the quality of their audits and not on nurturing a relationship that will make management more receptive to cross selling efforts."

This surely is an important problem but mandatory rotation would not alleviate it. It would instead create a musical chair syndrome that would only exacerbate the problem. Every year every one of the larger accounting firms would need to replace the firms they are losing as clients with the firms that other large firms are losing. Ernst & Young, for example, would be checking with Price Waterhouse to see which of their clients will be moving on. It is a certainty that the Big 4, and even the 4 next largest firms will be “working” with each other to switch clients.

The fact that each of the firms performs considerable non-audit work for non-audit clients further confuses the scene. You would have to assume that in the year or two before a firm loses the audit work of a client they will be “hustling” to get the non-audit consulting work of that same client in future years.

Ironically mandatory rotation would put enormous emphasis on salesmanship; on the ability to land a client.

Audit Committees should be required to have firm rules that give them complete oversight of any non audit work that the external auditing firm performs.

The Auditors Opinion and the Financial Statement

The biggest obstacle to substantial reform of the audit process is our prolonged failure to redesign the traditional financial statement used throughout the world. It was created in the days of bricks and mortar when the investment community was content to be given historical costs and a proposed period to depreciate those costs. If a table cost \$200 the only issue for the auditor was whether management’s proposal to depreciate that table over a period of, say, 10 years was reasonable.

The need to value intangible assets and the increased need to use current values rather than historical values for other assets have made the traditional financial statement obsolete. Today a large and growing number of asset values on financial statements are forged out of the estimates and assumptions made by management. The range of values available to even the most conscientious managers is enormous. Nevertheless, the current form of financial statement persuades a large part of the investing public that it has a precision that is utterly unrealistic.

All who have been seriously engaged in efforts to reform the system accept the warning of the Economist magazine in 2003 that “the brittle illusion of accounting exactitude . . . tends to collapse in periods of economic strain.”⁴ That illusion collapsed in the 1970’s with the conglomerate craze, it collapsed again in the 80’s with the dot. com. phenomena, and again at the beginning of this century with the Enron type accounting scandals.

That 2003 consensus referred to above from the “***Future of the Accounting Profession***” also concluded:

“The balance sheet of the future will be a more flexible instrument able to adapt to a wide variety of industries and circumstances. It will encompass a wider array of numbers so

⁴ “The future of accounts – True and fair is not hard and fast”, *The Economist*, 26 April 2003, pages 59-61.

that users recognize when management and auditors are making judgments on transactions and asset valuations that are not, and cannot be, 'hard and fast'." ⁴

Until that "balance sheet of the future" exists audit committees need to better evaluate the assumptions and estimates made by management in its construction of financial statements. Auditors should know that it is their responsibility to make certain that audit committees understand the alternatives that were open to management and that management's choice from those alternatives was a "fair" choice.

In short auditors and audit committees need to fully recognize that the financial statements for which they bear responsibility are in accordance with generally accepted auditing principles and that they also constitute a "fair" presentation of the company's financial position.

Finally, the role of the auditors would be better understood if their opinions made it clear that their attestation is primarily to the fairness of the process by which management has made its estimates and assumptions.

Summary

As noted above audit committees have for almost 36 years been the primary instrument used to improve the audit process. It is timely for new steps to be taken to increase both the independence and the efficacy of audit committees. Removing management from the selection of candidates for board membership is a particularly important objective.

It would, I believe, be tragic to abandon the audit committee to the bureaucracy of mandatory rotation.

Appendix A

1976 CORRESPONDENCE

BETWEEN

RODERICK M. HILLS
Chairman
Securities and Exchange Commission

AND

WILLIAM BATTEN
New York Stock Exchange, Inc.



SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

May 11, 1976

William Batten
New York Stock Exchange, Inc.
11 Wall Street
New York, N. Y. 10005

Dear Mil:

I want to take this opportunity to congratulate you again on your recent appointment and to wish you the best of luck. The job is a challenging one, but one I know you will fill with distinction. I speak for all the members of the Commission in saying that we look forward to working with you on the many complex problems facing the securities industry today. In that vein, I would like to advise you of a subject which Jim Needham and I have discussed informally in the past, and ask for the benefit of your thoughts.

As you know, the Commission has for many years advocated that publicly-held companies create audit committees, composed of independent directors, to work with outside auditors.*/ In our review of corporations who have revealed questionable foreign and domestic payments we have found an almost universal use of misleading financial records to conceal such corporate practices from outside auditors and directors and corporate counsel. The existence of an audit committee that meets privately with the outside auditors to discuss the scope of the audit, questions arising during the audit, including disputes with management, and that has access to the corporate financial information, is an important part of our effort to maintain the credibility of our system of corporate self regulation.

I am sure you are aware of the fact that the Auditing Standards Executive Committee of the A.I.C.P.A. has circulated an exposure draft of

*/ In 1940, following the McKesson-Robbins investigation, the Commission urged the formation of audit committees, composed of non-officer directors, to participate in arranging corporate audits. In 1972, the Commission endorsed the establishment of audit committees composed of outside directors for all publicly-held companies to provide more effective communications between independent accountants and outside directors, and thereby to safeguard further the integrity of corporate financial statements on which public investors rely. In 1974, in amending its rules to require disclosure in proxy statements of the existence or absence of audit committees, the Commission reiterated its support.

William Batten, Chairman
Page Two

a new auditing standard which, if adopted, would require auditors to bring any questionable payments that they may find to the attention of a level of management high enough for corrective steps to be taken. If questionable payments by top management are discovered, such an approach will, of course, be enhanced if an audit committee is in existence.

Additionally, there has been considerable recent comment about steps that can be taken to make the role of the board of directors more meaningful. Some major corporations have already taken steps to restructure their boards so that a majority consists of outside directors. Indeed, the Chairman of Connecticut General has recently written us about actions taken by that corporation to create a board consisting only of outside directors and the chief executive officer. While we have no firm notion about the optimum relationship between outside and inside directors, we do believe it is a subject of considerable importance.

Finally, many thoughtful commentators and many major law firms have come to the conclusion that the effectiveness of the board of directors and independent counsel is enhanced when the critical aspects of the two functions are kept separate. This, of course, raises the question of whether members of law firms which have the responsibility of advising the corporation, including the board, should also serve as members of that board of directors.

The importance of maintaining the truly independent character of the boards of directors of our larger corporations has been illustrated by the Commission's recent enforcement actions in the area of questionable or illegal corporate payments. Significantly, in some of these cases no audit committee existed. In the others, with a single exception, audit committees were either only operated during a portion of the time when the questionable payments were alleged to have been made, or not wholly independent of management. Accordingly, the resolution of these actions typically has involved the establishment of a committee comprised of independent members of the board of directors in order to conduct a full investigation, utilizing independent legal counsel and outside auditors to conduct the necessary detailed inquiries. The thoroughness and vigor with which these committees have conducted their investigations demonstrates the importance of establishing entirely independent audit committees as permanent, rather than extraordinary, corporate organs and encouraging the Board to rely on independent counsel.

William Batten, Chairman
Page Three

With these thoughts in mind, we have been considering various approaches to increase the likelihood that larger public corporations will establish audit committees composed of outside directors, that they will take further steps to make the role of the board of directors more meaningful, and that corporate boards will deal with independent counsel. One particularly promising approach to accomplish these goals would be for the Exchange to amend its policies and practices. As the Company Manual points out, the Exchange's listing agreement constitutes a code of performance to which companies commit when listing their securities on the Exchange. When the listing agreement was first instituted in 1899, the Exchange took the lead in the field of financial disclosure by requiring regular financial reports from listed companies; subsequently, independent public accountants were required.

The Exchange's listing policies have expanded in scope over the years. Specifically, the Exchange has long urged the desirability of including outside directors on corporate boards and specifically charging them with ensuring full disclosure of corporate affairs. In its 1973 White Paper on financial reporting, the Exchange recommended that audit committees, preferably comprised exclusively of outside directors, be formed. This recommendation represented a reaffirmation of a principle first raised by the Exchange in 1940.

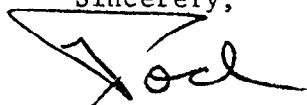
In keeping with this tradition, the Exchange now could take the lead in this area by appropriately revising its listing policies, thus providing a practical means of effecting these important objectives without increasing direct government regulation. The objectives are sound in principle and, if implemented, they would significantly advance the public interest.

We would very much appreciate receiving your views on whether the New York Stock Exchange would find it appropriate to alter its listing policies along the lines discussed above. We are sensitive to the fact that, to the extent the Exchange's listing policies impose burdens which corporations might otherwise avoid, the attractiveness of listing on the Exchange may be diminished. But, at the same time, the Exchange has frequently recognized that it could provide effective leadership where its initiatives were consistent with developments in public policy in the fields of corporation finance, management, stockholder relations and accounting, and recent surveys suggest that perhaps two-thirds of NYSE listed companies already have independent audit committees.

William Batten, Chairman
Page Four

We look forward to receiving the benefit of your views, particularly as to what Commission action, if any, in this area would be useful. We would be pleased to meet with you to discuss these matters further.

Sincerely,

A handwritten signature in black ink, appearing to read "R. Hills", written over a horizontal line.

Roderick M. Hills
Chairman