



March 12, 2012

Office of the Secretary PCAOB 1666 K Street, N.W. Washington, D.C. 20006-2803

RE: <u>PCAOB Rulemaking Docket Matter No. 37 - CONCEPT RELEASE ON</u>
AUDITOR INDEPENDENCE AND AUDIT FIRM ROTATION

Dear Board Members and Staff of the PCAOB:

In speaking with you today, I am representing The Institute of Internal Auditors (IIA), which I have the honor of serving as Chairman of the North American Board. We appreciate the opportunity to share our views regarding the Concept Release on Auditor Independence and Audit Firm Rotation, and we commend the Public Company Accounting Oversight Board's continued efforts to enhance auditor independence, objectivity, and professional skepticism. Auditor independence, objectivity and professional skepticism are the foundation of audit quality, and they are essential for maintaining trust in our financial systems and in the financial reporting process.

Background

The IIA represents more than 173,000 internal auditors in 165 countries, including over 63,000 members located in the United States. The IIA is the global voice, acknowledged leader, principal educator, and recognized authority of the internal audit profession and maintains the *International Standards for the Professional Practice of Internal Auditing*.

Internal auditors, external auditors, management, and boards work together as the four cornerstones of effective corporate governance. Internal auditors and external auditors have interlocking goals, and members of the internal auditing profession work closely with external auditors to bring a systematic, disciplined approach to evaluating the effectiveness of internal controls over financial reporting and related disclosure controls. As a result, auditor independence, objectivity, and overall audit quality are very important to us.

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An effective internal audit activity provides audit committees and boards with assurance and highlights improvement opportunities related to the organization's governance, risk management, and internal controls, including audit quality related to an organization's financial statements. The internal audit profession's globally adopted *International Standards for the Professional Practice of Internal Auditing* require that chief audit executives share information and coordinate activities with external auditors and with other internal and external assurance providers in order to ensure proper audit coverage and minimize duplication of efforts.

The IIA believes that because of the unique nature and vantage point of the internal auditing profession, we are able to offer insights regarding auditor independence that will be of significant value in your deliberations. We believe the establishment of the PCAOB and other recent reforms have significantly improved audit quality and auditor independence. We are highly supportive of additional efforts to increase the overall efficiency, effectiveness, and quality of financial statement audits. However, while we understand the rationale behind mandatory auditor rotation, we strongly believe the risks of unintended consequences and the costs will outweigh the benefits and are too great to support the proposal. While we recognize that mandatory auditor rotation might bring marginal improvements in auditor independence, we believe more effective alternatives exist for improving the overall quality of audits.

Opinions Based on Research

When the IIA surveyed its members regarding a potential requirement for auditor rotation, the majority of respondents to the survey indicated that audit firm rotation could marginally enhance independence and objectivity; however, the majority *disagreed* with the overall concept of audit firm rotation because of disadvantages such as loss of company-specific knowledge, steep learning curves for newly assigned auditors, significant work disruptions, increased costs and, most important, the risk of a significant decrease in overall audit quality.

We must never forget that the underlying reason to consider a move toward mandatory audit rotation is to improve the quality of auditing. Though mandatory auditor rotation could provide minor incremental improvements in independence and objectivity, we have serious concerns about the impact of such a move on auditor knowledge, effectiveness, and efficiency.

These are high prices to pay for what might be at best a marginal increase in audit independence – and I believe the increase would, indeed, be marginal. In The IIA's survey, the perception of the majority of internal auditors whose companies experienced a change in auditors was that the independence, objectivity, and professional skepticism of the new auditing firm were not markedly different from that of the prior firm. The potential benefit in this area may already have been realized through existing requirements for rotation of lead and reviewing audit partners.

The internal auditors surveyed by The Institute of Internal Auditors felt that there might be other unintended consequences from mandatory auditor rotation. Mandatory rotations might have cost, efficiency, and effectiveness impacts not only on the incoming audit firm, but also on the incumbent firm, where client service, timeliness, and quality issues might arise during the last year of the engagement. As described below, the move might inappropriately diminish the role and influence of the audit committee. Mandatory rotation could also create potential opportunities for opinion shopping. Each of these effects could have consequences that would be exactly the opposite of what was intended by a requirement for mandatory rotation.

Audit Quality

I am happy to note that significant improvements have been made to audit quality over the past decade. Legislation and regulation such as the Sarbanes-Oxley Act of 2002 have put in place much-needed reforms to enhance auditor independence and audit quality, including of course the establishment of the PCAOB itself. Today, audit partners who do not pass peer reviews, internal reviews, or PCAOB reviews often face serious consequences. Mandatory rotation of lead and reviewing audit partners, prohibitions on the provision of most non-auditing services by the external auditing firm, requirements for the audit committee to pre-approve all audit and non-audit services not otherwise prohibited, and other initiatives to improve audit quality all have had a marked effect.

While the full impact of these changes cannot yet be estimated, recent data indicates that the reforms are working – and working well. According to a study conducted by Audit Analytics, for example, the impact of the average restatement of net income by companies traded on one of the three major American stock exchanges (Amex, NASDAQ, and NYSE) decreased by a full 93 percent in 2010 compared to 2002. This is a truly remarkable improvement for only an eight-year period, and while many factors contributed to this change, we believe the improvement was brought about at least in part because of recent improvements in audit quality.

Only time will tell how far the current trends in audit quality will go, but I am confident that the quality of financial statement auditing will continue to improve into the foreseeable future. In the current environment of enhanced audit committee and investor oversight, we may well find that stringent new measures to improve audit quality are not needed.

It is important to remember that true audit quality cannot be achieved merely by increasing auditor independence and objectivity. In some markets, the availability of qualified alternative firms for auditor rotation is very limited and/or non-existent. If a mandatory rotation schedule is imposed, it may require switching to a firm less well-versed in the company's industry, and/or introduce additional unnecessary cost to "bring in" the industry skills needed to serve clients.

Audit Committee Oversight

Just as we have seen notable improvements in audit quality in the last decade, we have also seen noteworthy changes in our audit committees. Under our current system, audit committees are charged with hiring and firing the auditor, and with reviewing and approving the auditor's audit plan and related compensation. I believe that no other group is in a better position to oversee the work of the external audit firm on a continuing basis or to judge the appropriateness of a move to a new auditing firm.

Recent research in the Journal of Accountancy stated, "In the pre-SOX study, most audit committees were deemed passive and ineffective. However, in the current study, 86 percent of respondents indicated that the audit committee was now a serious group fulfilling an important role in monitoring the functioning of internal controls."

I personally believe that audit committee reforms are rapidly improving the quality of publicly available financial information and that we will continue to see future improvement in this area. Given the growing financial expertise and improved oversight structures developed by American audit committees, it seems unfortunate that this is a point in time when their role in auditor selection and approval might be replaced by a "one-size-fits-all" mandatory rotation schedule.

Knowledge Transfer and Company-Specific Knowledge

As a chief audit executive, I am keenly aware that auditors need sufficient knowledge and understanding of a company, its processes and controls, and the industry and its unique risks in order to effectively deal with complex accounting and auditing issues. I am sure that any of you who have worked with either internal or external auditors can appreciate the ongoing challenges of bringing new auditors up to speed on company-specific and industry-specific audit issues. Just as the audit of certain industries requires significant industry experience, the audit of certain highly complex organizations is improved by a strong knowledge of the organization under audit. The new auditors are the ones whose work we need to watch the most closely.

Can there be advantages to changing audit firms? Certainly there are times when changes are necessary in the selection of both internal and external auditors. But I believe those changes should be made only after careful consideration of a number of factors related to audit quality rather than according to an arbitrary rotation schedule, because changes in auditors can result in a loss of information that could at some point prove crucial to the success or failure of an audit.

Timing Issues

As I noted earlier, financial statement auditing and its oversight by audit committees are undergoing a major period of transition. Because our processes and systems are in flux, it might be impossible to evaluate the impact of a change to a mandatory audit firm rotation schedule. If we make this change at a time when so many other changes are being implemented, we might never know whether mandatory audit rotation leads to improved audit quality – or whether, as many internal auditors believe, the change would lead to an overall decrease in audit quality, especially in the first or second year after a required change. If financial reporting continues to improve, as I believe it will, there will be no practical way to evaluate whether the improved reporting resulted from mandatory rotation, or conversely whether it was the result of other unrelated changes.

Financial Impact

There can be no doubt that mandatory rotation would increase the costs of auditing. The November 2003 GAO report on the potential effects of mandatory audit firm rotation summarized survey results received from the largest public accounting firms and Fortune 1000 public companies by stating, "...We estimate that following a change in auditor under mandatory audit firm rotation, the possible additional first-year audit-related costs [inclusive of increased audit fees, company selection and support costs] could range from 43 percent to 128 percent higher than the likely recurring audit costs had there been no change in auditor."

These very significant cost estimates do not include other substantial costs such as the increased time demands placed on the audited company, its financial reporting staff, its internal auditors, and its audit committee members. As a chief audit executive, I can assure you that the increased time demands placed on internal auditors and on audit committees will be significant. But while the dollar costs and time demands of mandatory rotation might be high, these costs are not the main reason for my concern.

In The IIA's survey, internal auditors whose organizations had experienced a change in financial statement auditors indicated that audit costs increased in the early years after a change in auditors but that these costs declined over time. More important was the fact that similar trends were noted with regard to efficiency and effectiveness. I believe that cost is only one of a number of factors that should be considered in determining whether or not auditor rotation is justified. Factors such as experience, expertise, number of firms available to be considered, and length of time to get up to speed on the organization subject to audit should all be considered. Unfortunately, each of these factors will be affected if an arbitrary time schedule is imposed for auditor rotation.

Recommendations

As you can tell from my earlier comments, I am strongly opposed to mandatory rotation of external auditing firms based on a fixed time schedule. Much of the potential benefit of auditor rotation has already been achieved through mandatory partner rotations, and any incremental benefit from requiring audit firm rotation is not clear. I believe these incremental benefits would be nominal and that we may actually damage the quality of our financial statement audits by mandating a "one-size-fits-all" approach to auditor selection.

Members of The Institute of Internal Auditors believe that actions other than mandatory auditor rotation could be taken which would be more likely to result in overall improvement in audit quality, at less risk and at less cost than we would expect from a change to audit rotation requirements. The IIA strongly believes that the following alternatives to mandatory rotation based solely on passage of time should be considered:

- Introducing a mandatory change of auditors in limited circumstances such as financial statement fraud.
- Requiring increased disclosure about the audit committee's role in overseeing the quality of the audit, including its periodic evaluation of auditor independence.
- Implementing a system whereby audit committees could request the PCAOB to perform an enhanced inspection of the audit of their company, with reporting of results to both the company and its auditors.

We believe that it should be the responsibility of each audit committee to review their audit firm's performance annually and recommend changes when deemed necessary. The organization's internal audit function can greatly support this assessment, and we encourage the PCAOB to consider ways in which the review process might be improved.

In the quest to improve audit quality, I also believe we need to work toward strengthened coordination between internal auditors and external auditors, to leverage the knowledge, skills, experience, and expertise of internal audit. This enhanced coordination could lead to a deeper understanding of company risks and controls and to a more appropriate reliance on internal audit results, thereby enabling external auditors to concentrate more of their resources on higher-risk areas.

In summary, I believe the establishment of the PCAOB and other recent reforms have significantly improved audit quality and auditor independence. I applaud the Board's efforts to address the financial reporting concerns of investors and other users of financial statements, especially in light of the recent global financial crisis. I believe the Board should continue to focus on ways to enhance auditor independence, objectivity, and professional skepticism. To this end, rather than requiring mandatory firm rotation, the PCAOB should consider each of the alternatives presented earlier, with the goal of increasing the overall efficiency and effectiveness of auditing without incurring the significant risks inherent in mandatory auditor rotation.

I welcome the opportunity to discuss any and all of these comments with you, and The Institute of Internal Auditors would be honored to assist the PCAOB in this or in any other upcoming initiative that impacts the quality of auditing.

Thank you for your consideration of my remarks.

Larry Harrington

Best regards,

Lawrence J. Harrington, CIA

Chairman

North American Board

The Institute of Internal Auditors