

Prepared Testimony to the Subcommittee on Capital Markets and Government  
Sponsored Enterprises

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On Behalf of Financial Executives International  
March 28, 2012

I would like to begin by thanking Chairman Garrett, Ranking Member Waters and the members of the Subcommittee on Capital Markets and Government Sponsored Enterprises for inviting me today to discuss a number of current issues and matters affecting the state of the U.S. accounting and auditing professions. Today I am representing Financial Executives International (FEI) – a leading international organization of senior financial executives. I am the chairman of the FEI's subcommittee on relations with the Financial Accounting Standards Board (FASB). For the last 11 years I have been Chief Accounting Officer of Xerox Corporation, a \$23 billion multinational corporation which operates in over 160 countries. The perspectives I will share with you today will be from the perspective of a financial statement preparer.

The accounting and auditing professions are large, dynamic and crucial to the smooth and efficient functioning of our economy and its capital markets. Like any large profession the list of current issues under consideration for change is long - as it should be – reflecting: the professions' continuous efforts for improvement; emerging issues and current needs of financial statement users; and reflection on the continuing applicability and on-going value of past decisions.

There are three subjects I would like to discuss with you today – they are:

- Mandatory Rotation of Auditing Firms
- Complexity in Accounting Standards
- Principles Based Accounting Standards

### **Mandatory Rotation of Auditing Firms**

#### **Key messages:**

- The FEI recognizes and has always supported the critical need for auditor independence and impartiality however there is no guarantee that mandatory rotation of auditing firms will increase auditor independence and thus result in higher quality audits which is the primary goal. However it is clear that mandatory rotation will be costly and operationally disruptive.

- There are many reasons the financial statement preparer community opposes any requirement to periodically rotate a company's external auditors. This presentation focuses on practical operational implications and costs.
- For the larger multinational corporations (MNCs) realistically only the Big 4 firms have the global resources to effectively perform the audit.
- The process for selecting a new auditor and transitioning in a new auditor will be extremely costly for both the company and the new auditor. Company time and money are finite – every hour and dollar spent on changing auditors is not available for other uses in the business or return to investors.
- Many MNCs have non audit relationships (i.e. consulting, valuation, internal auditing, etc.) with one or more of the Big 4 firms which would often need to be curtailed if such firm was to be selected as the new auditor. This leads to additional business disruption to replace that firm in its non audit capacity. Alternatively, companies may decide to never retain a Big 4 firm to perform non-audit services as one day that firm may become the new external auditor.
- As big as they are the Big 4 firms are not necessarily fungible. They vary in industry concentrations and expertise, geographic presence and international reach which may limit the potential for selection as a new auditor.
- Many complex capital markets and M&A transactions may extend over several periods with one auditor present at the beginning and another present at the end. This creates its own set of costs and complications.

**Discussion:** The preparer community has been closely following this issue and is virtually unanimously opposed to any regulations which would require the mandatory rotation of a company's independent auditors. This Committee has or may hear the detailed pro and con arguments in favor or opposed to auditor rotation.

My objective today is to describe what some of the disruptive effects on a company's operations would be if periodic auditor rotation became a requirement. As I will discuss the financial, operational and cost implications are significant.

- For large multinational corporations (MNCs) realistically only the Big 4 firms have the capacity to perform a quality global audit in accordance with the standards of the PCAOB. This means there are only three potential alternatives when a MNC needs to change auditors. Contrast that to say the number of large banks or law firms who may be available for a given service.
- In some instances it is possible that there would not even be 3 of the Big 4 available. Each of these firms have varying industry expertise and

geographic presences and there are degrees of industry concentration within them. Thus the practical number of choices for new auditor selection may be less than 3.

- The Big 4 firms have enormous global capabilities and their non-audit practices place them among the largest consulting firms in the world. They each bring to the table a vast array of non-audit financial and other consulting services which most MNCs use in some capacity. The business issue is that many of these services (nine are enumerated in regulation) are prohibited from being performed by a company's audit firm – generally as an impairment to independence.
- For example implementing computer processing systems is a competency each of the Big 4 have. Systems projects often occur over several years. When an audit rotation interval comes up the Big 4 firm involved in the systems project would likely be ineligible to become the next auditor. What does a company do as there are no good choices:
  - Do not hire the Big 4 firm to do the system project in the first place even if it is otherwise highly qualified and cost effective?
  - During the middle of the systems project replace the Big 4 firm with another vendor and hope the vendor transition is seamless?
  - Limit the new auditor selection to only 2 of the Big 4?
- Another business disruptive example involves a company's internal audit function. Many MNCs – including my own – have outsourced internal auditing to a Big 4 firm other than their auditor. Internal audit outsourcing is a large line of business for many audit firms however it is a prohibited service for the external auditor to perform for his audit client. As with systems vendors, a company is only left with poor choices:
  - Select the firm with the internal audit contract to be the new external auditor, terminate their internal audit relationship and change the internal audit outsourcer to another major accounting firm;
  - Bring the internal audit function in house but in doing so a company would have to establish a new department and then identify and train qualified internal finance staff to do the function;
  - Leave the internal audit function where it is outsourced and limit new auditor selection to only 2 of the Big 4.
- There are many other examples that could be cited however it is very likely that most MNC's retain at least a few of the Big 4 firms to perform professional services that would be prohibited to be done by the external audit firm.
- Capital markets transactions and major acquisitions are complicated, big dollar business critical transactions with significant amounts of capital and risk often present. Often these transactions will span several quarters from launch to closing including over a fiscal year end. What happens if during the course of a lengthy transaction the required audit rotation interval occurs – i.e. one Big 4 firm is present at the beginning but another signs off at closing? This is a hugely important issue and concern. In

- these circumstances extensive and complicated coordination between the predecessor and successor auditors is required. Both audit firms would have to concur on all significant accounting and auditing matters and a protocol to share audit findings would need to be developed. There would result in otherwise unnecessary costs (i.e. different firms signing comfort letters to underwriters, consents and expertization in registration statements, subsequent events reviews, different auditors signing off on different years in the financial filings, etc.). Capital markets and M&A transactions are frequently costly and complex and a required auditor change during the life of one would be an unwelcome and costly event.
- For large companies the process for new auditor selection is lengthy and expensive. For a MNC it may be necessary for the prospective auditor to visit several locations and commit to extensive due diligence in order to assess a company's internal controls, nature of records, operational matters affecting the audit etc. in order to prepare a meaningful proposal to become the new auditor. For a company's management it may have to repeat this process with several firms. Once the bids are in, extensive senior management time is necessary to evaluate them, conduct interviews and presentations. During this process the company's audit committee would need to become engaged, conduct their own interviews, evaluate management's assessments, etc. before finally selecting the new auditor. Much of this work would occur while the out going auditor is present and wrapping up his final year on the engagement.

The institutional knowledge the predecessor auditor has is lost when that firm leaves the engagement as it is not transferable to the new auditor. Thus, once the new auditor is selected management must commit extensive support time to assist the new firm in learning all the financial details about the client. It is easy for first year audit time to exceed by 50% or more the steady state effort and it may take several years to get to the steady state.

In summary, requirements to mandate the periodic rotation of auditing firms will have significant operation consequences and cost increases to the companies they audit. The above examples are among the more significant implications however there are many more that can be enumerated.

## **Complexity in Accounting Standards**

### **Key messages:**

- Complexity in accounting standards, including the related disclosure requirements, is a significant issue for the preparers of financial statements.
- Some complexity is unavoidable and appropriate but some can and should be avoided.
- Unnecessarily complex accounting standards results in significant operating costs to preparers.
- To the extent possible, new accounting standards should result in financial statements which reflect a company's business model.
- Cost of implementation and ongoing compliance should receive greater prominence in the FASB's decision process for new standards.
- The FASB currently conducts extensive outreach when developing new accounting standards and the FEI strongly encourages such be continued in perpetuity. The FEI wishes to recognize Chairman Seidman's efforts during the almost two years she has chaired the FASB. In an effort to test the operational viability of potential new standards the FASB has been conducting greater than ever outreach – both in frequency and visibility – to its various constituencies including the preparer community.

**Discussion:** The complexity of many accounting standards is a matter of significant importance and concern to the preparers of financial statements, the senior management of their companies and to the audit community. Unnecessarily complex accounting standards almost certainly result in increased operational and audit costs for financial statement preparers and increase the potential for financial statement errors. The FEI has long been a proponent of improvements to financial accounting to address investor needs and works very closely with the FASB in a continuous dialogue regarding the development of new accounting standards and in the ongoing evaluation of existing standards. To be sure, some complexity is inevitable and the complex nature of some transactions can only be properly addressed by complex accounting standards. There are many root causes behind the complexity in accounting standards including (but not limited to):

- Culturally the US tends to be a rules based society so it is logical that accounting standards also contain a large rules based element.
- The FASB and its predecessor standards setters have historically been guided by an overarching goal of achieving consistency and comparability in the recognition, measurement and presentation of transactions between different companies. Thus a tendency towards detailed rules and a 'one size fits all' approach in the promulgation of new standards.

- Building on the preceding point, in an effort to achieve consistency new accounting standards released over the last few decades have tended to be very detailed in trying to provide guidance for many lower level implementation issues and variants found in practice.
- The cost of compliance with new accounting standards has frequently not been a significant factor in the establishment of new standards. In this context 'cost' means the internal operating costs to develop new procedures and information systems and the ongoing costs of compliance including internal staff time and external audit fees.

While the FASB's mission is to enhance the decision usefulness of accounting information for investors and other users of financial statements, the FEI strongly recommends that new standards should also be developed with due consideration of the preparer community's operational capability in a cost-effective manner. Stated differently, improvements to accounting standards and cost effective, less complex new requirements need not be mutually exclusive. FEI recommends to the extent reasonably possible new accounting principles:

- Be developed considering the business models of the affected companies;
- Recognize that companies are different from each other – even than those in the same industry – such that it is reasonable to assume that similar transactions may be accounted and presented differently but still produce decision useful financial statements;
- Recognize that there will be occasions when there is more than one equally reasonable and decision useful alternative accounting treatment for a given type of transaction or event;
- Increase the weighting that cost of implementation and compliance receives in the FASB's decision process;
- Allow for reasonable flexibility in the transition rules for the initial adoption of new accounting principles;
- Minimize unnecessary complexity even at the expense of permitting some variations in practice – see next section below on Principles Based Accounting Standards.

## **Principles Based Accounting Standards**

### **Key Messages:**

- The FEI has long been a strong proponent of principles based accounting and encourages the accounting standards setters to promulgate new standards with more emphasis on principles and less on detailed rules and implementation guidance.
- The FEI has noticed a recent change by the FASB in this direction but notes that old habits (i.e. drafting very detailed guidance) are often hard to

- break and there remain many accounting standards on the books that include extensively detailed rules.
- Unnecessary complexity and higher compliance costs tend to be by-products of rules based accounting standards.
  - Principles based accounting standards will require (1) the acceptance of good faith application of judgment by all constituencies in the accounting, reporting and auditing communities and (2) recognition that there may be slightly less comparability between companies in the future as local judgments may be different.

**Discussion:** FEI has been a strong proponent for principles based accounting for many years. The question often comes up – what’s the difference between rules based accounting and principles based accounting? The simple answer involves the level of detail provided by standards setters such as the FASB and IASB. Rules based accounting standards always begin with basic principles but then expand from there. Rules based standards frequently attempt to provide guidance for as many transaction variants and combinations and permutations as have been identified by the staff as existing in practice. The high level objectives for detailed rules are generally laudable – consistency in practice, implementation guidance, detailed standards to audit against, etc. Although most interested parties in the accounting and auditing communities regularly profess to be supporters of principles based accounting the reality is that after several decades of primarily rules based new standards it is difficult to quickly change philosophical direction. FEI has noticed the winds of change appear to be gathering and strongly encourages the direction. However old habits are always a challenge and there are many, many standards on the books with heavy detailed rules content.

Some of the drawbacks of rules based accounting principles include:

- Complexity is definitely increased as the final accounting standards are much longer and frequently it is not always clear which individual rule applies in a given situation because:
  - All possible variations in practice cannot be covered by detailed rules
  - Detailed rule making tends to invite exceptions.
  - Precise and detailed rules offer the opportunity for transaction structuring around and between individual rules.
  - The ability to apply judgment is often limited.
  - Costs of implementation and ongoing compliance will frequently be higher because it may be more difficult to apply detailed rules than higher level principles.
  - Detailed rules and resulting complexity increase the chance of error and restatement.
- It generally takes longer for standard setters to finalize new accounting standards if for no other reason than the mere length of the final document and level of details provided.

- Detailed rules based standards often detract from the basic, high level goals of the new accounting standard.

While FEI recognizes that some level of detailed rules are inevitable and appropriate, we strongly recommend that the future direction of accounting standards setting stay primarily focused on promulgating principles and resist, to the extent possible, the historical urge for extensive rules. Effective deployment of a principles based accounting system may require certain changes in practice such as:

- Acceptance by all constituents that good faith judgment will play a greater role in the future recognition, measurement and auditing of transactions
- Acceptance by all constituents that in a principles based system there will be some variations in practice – frequently in timing as opposed to overall end results - but the reduction in complexity and lower compliance costs will be offsetting benefits.
- There may be slightly less comparability of financial statements between companies because local judgments may be different.
- A standard or framework for how to apply and assess judgment may need to be developed by accounting, auditing or regulatory bodies.

In summary, there are many benefits to principles based accounting standards but they do come with the potential for slightly less consistency in practice and the need for a greater role in good faith judgments by all involved parties.

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I would be pleased to take questions from the members of the Subcommittee and would be available at a later date to discuss in greater detail any of the matters reviewed today.





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## COMMITTEE ON CORPORATE REPORTING

December 14, 2011

Office of the Secretary  
Public Company Accounting Oversight Board  
1666 K Street, N.W.  
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No.37

Dear Board:

The Committee on Corporate Reporting (“CCR”) of Financial Executives International (“FEI”) appreciates the opportunity to share its views on the Public Company Accounting Oversight Board’s (“PCAOB” or “Board”) Release No. 2011-006, “Concept Release on Auditor Independence and Audit Firm Rotation” (“the Release”). FEI is a leading international organization of senior financial executives. CCR is a technical committee of FEI, which reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. This document represents the views of CCR and not necessarily the views of FEI or its members individually.

Although we support the Board’s efforts to evaluate ways to enhance auditor independence, objectivity and professional skepticism, and improve overall audit quality, we oppose mandating audit firm rotation. We believe there is a lack of empirical evidence to support the Board’s hypothesis that mandatory audit firm rotation will improve auditor independence, objectivity and professional skepticism, and that there are other ways to enhance these areas. Our opposition is primarily based upon the potential negative impacts to audit quality, especially around the time of a rotation, the anticipated increase in overall audit costs that will likely result from such a requirement, and operational challenges in connection with identifying successor auditors upon a rotation. We recommend that any changes to enhance auditor independence, objectivity and professional skepticism should potentially be part of a holistic approach that further enhances the role of the audit committee in overseeing the independent auditor. We are also concerned that mandatory audit firm rotation would lead to significant operational challenges due to the limited number of audit firms with the industry experience and international presence required to perform audits for large multi-national issuers. Lastly, we are concerned that mandatory audit firm rotation would be a drastic measure impacting hundreds of registrants to address concerns that appear to be arising in only a limited number of audit inspections.

### ***Risks to Audit Quality***

An audit firm accumulates knowledge of its audit client over an extended period of time. We believe there is a distinct and important difference between (i) the minimum level of knowledge of a company and its control environment that the auditor is required to obtain in order to conduct an audit in accordance with the standards of the PCAOB and (ii) the level and depth of such knowledge that is built and accumulated over time. Extensive experience

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with a company drives an appreciation for historical transactions and trends as well as an understanding of an issuer's control environment. An audit firm develops a deep understanding of an issuer's accounting policies, procedures, processes and information systems through experience over time. As this knowledge base grows, the audit firm is far better able to challenge management's judgments and assumptions that underlie significant accounting estimates and other complex accounting and disclosure determinations.

An audit firm must climb a steep learning curve in the early years of an audit relationship with a new client, especially on large multi-national company audits where the audit work may be performed by several audit firm offices and/or member firms. It could easily take several years before an audit firm has developed a deep level of knowledge of the company. During these early years of the audit relationship, we are concerned that an auditor's lack of in-depth knowledge of the company and its history may adversely affect audit quality. The potential risks relate to new auditor's difficulty challenging management's assumptions and judgments due to the auditors' limited knowledge of the company, its history and industry. Although detection risk is inherent within the auditing model, a more mature relationship between the external audit firm and the company significantly mitigates the risk. The audit firm's specific experience with the company provides a greater foundation from which the auditor can assess the company's conclusions and to formulate their own professional judgments. Additionally, some academic studies suggest that auditors with longer tenure demonstrate increased audit quality, including the 2002 study by Geiger and Raghunandan (Geiger, Marshall A. and Raghunandan, Kannan, Auditor Tenure and Audit Reporting Failures, *Auditing: A Journal of Practice & Theory*, Vol. 21, No. 1, March 2002). Geiger and Raghunandan's analysis found that there was an adverse correlation between the propensity of audit failures and audit firm tenure, resulting in significantly more audit failures during the early stages of the audit relationship.

Specifically related to the notion that in some instances audit firms with a long-standing tenure could lack objectivity and professional skepticism, we believe the current five year rotation period imposed on the lead and concurring review audit partners adequately addresses these concerns. In our members' experiences, the engagement partners typically possess a broad understanding of the general business, industry specific and unique risks facing the company, and are the audit team members who maintain the closest relationships with the executive management of the company. However, our members see the greatest levels of in-depth knowledge of the company's policies, procedures and information systems reside with the experienced staff audit team members (e.g., managers, senior associates) as they perform the majority of the detailed audit procedures. We believe that the current mandatory rotation of the engagement partners coupled with the established company knowledge retained throughout the remainder of the audit engagement team allows for both a fresh perspective and depth of knowledge that is necessary to perform a high quality audit. In fact, we believe that longer audit tenure and mandatory partner rotations exemplify the combination of experience and independence necessary to achieve the desired level of objectivity and professional skepticism. Furthermore, there is no clear evidence that longer audit firm tenure adversely impacts an auditor's independent mindset and objectivity.

### ***Increased Costs***

We also believe that any mandatory audit firm rotation will likely result in increased audit costs. These increased costs will be both direct financial costs and indirect costs associated with lost time and productivity. The 2003 GAO study estimated an increase of 17% in audit fees as a result of a mandatory audit firm rotation requirement (Government Accountability Office, 2003, Required study on the potential effects of mandatory audit firm rotation). Our members' experience suggests audit firms currently absorb (i.e., do not bill to the client) much of the first-time non-recurring costs associated with a new audit engagement. We are

concerned that a mandatory firm rotation will change the marketplace dynamic such that more of these costs are billed to the audit client. We do not believe that it is in the best interest of the investors to burden them with these increased expenses without specific understanding of direct benefits from these costs.

We expect that companies will be significantly impacted by the lost productivity amongst various levels of a company's organization as a result of a mandatory audit firm rotation. Certain of our members have recently undertaken a voluntary change in audit firms and have directly experienced significant lost productivity as a result of the time necessary to educate the new audit firm's personnel on the company's background, control environment, accounting practices and information systems.

There also will be significant costs involved in changing the audit firm at various subsidiaries around the world where statutory audits are required. In most cases, our members seek to use the same audit firm that audits their consolidated financial statements to also perform any required statutory audit work in foreign subsidiaries. This is done for a variety of reasons, including managing the overall coordination and effectiveness of such arrangements as well as overall cost considerations. For many companies, this would mean not just a change in the auditor at the parent company level, but also the auditor at all such subsidiaries. We believe this introduces substantial additional costs into the audit process without a proven benefit to investors or the public interest.

### ***Operational Challenges***

We are also concerned that significant operational challenges will arise under a mandatory audit firm rotation requirement due to companies' limited options when selecting a successor audit firm. These limitations may arise due to concerns with certain geographic requirements, sufficient industry expertise and potential independence considerations.

Practically speaking, most of our members would need one of the Big 4 audit firms to perform the audit due to the overall size and complexity of the engagement. Further, the potential audit firms would need to have a deep understanding of and experience with their industry and have an international presence appropriate to meet the needs of the consolidated audit and various statutory audits. These complexities result in significant limitations to the population of potential audit firms who possess the size, international presence and overall expertise to meet the demands of our members' audit requirements.

With an already limited audit firm pool from which to choose due to size and industry expertise of the audit firm, we are also concerned with the impact that independence would have on mandatory audit firm rotation in regards to identifying a potential successor audit firm. Currently, most of our members use one of the Big 4 audit firms to perform the audit, while also utilizing one or more of the remaining Big 4 firms to perform non-audit services the auditor is prohibited from performing (i.e., valuation services or internal audit outsourcing). In these circumstances, our members' audit committee's could find themselves with very few, if any, options that would not also involve changing a non-audit service provider. If audit firm rotation were required, many of our members would undoubtedly find themselves in a situation where they would have to rotate a Big 4 firm out of the non-audit services space in order to establish their independence and thus eligibility to perform the audit. This rotation must be completed well before the time of mandatory rotation, which would further constrain and complicate the selection process of the new audit firm as well as cause a significant disruption to management's processes as some of these services could take a significant period of time themselves to transition and likely result in increased costs.

The pervasiveness of these limitations would be a significant hurdle that all large, international issuers would be forced to address. The compounded nature of these limitations realistically reduces the number of audit firms who could adequately perform the audit, while causing an unnecessary disruption to management's processes.

### ***Audit Committee Corporate Governance***

We are concerned that mandatory audit firm rotation will preclude audit committees from effectively fulfilling one of their chief governance responsibilities. Currently, audit committees select the audit firm that they believe best meets the company's and investors needs. Further, audit committees have the right to implement a change in audit firms at any time and have exercised this right when they considered it appropriate to do so. We believe that the audit committee is in the best position to determine who will perform the audit and when it is appropriate to make a change in audit firms and that mandatory audit firm rotation significantly impedes the exercise of this discretion. For example, an audit committee may be forced to make a decision which is not in the best interests of investors by having to change audit firms in the middle of a complex business development transaction, registration statement or spin-off which could delay the transaction and put investors at greater risk.

### ***Other Actions to Consider***

With respect to the Board's initiatives regarding the enhancement of audit quality, we believe that there are other potential solutions that could achieve the desired goals without mandating an audit firm rotation model. These include the expanded distribution of inspection comments to the issuer's audit committee and more timely distribution of formal PCAOB inspection results.

The audit committee's oversight role directly includes the responsibility to oversee the overall quality of the audit and audit firm including assessing independence, objectivity and professional skepticism. To further improve this aspect of audit committee governance, a natural first step would be to enhance the information available to the audit committee for use in their assessment of the audit firm. While we recognize there may be limitations under the laws and regulations that exist today, one alternative solution is for the PCAOB to revise the auditor's required communications with the audit committee to include its firm's inspection results, including, where applicable, any audit engagement-specific results. We believe audit committees are generally effective in their oversight of the audit firms and believe that this additional knowledge, specifically related to the effectiveness of their audit firm and team, would allow audit committees to more proactively address any potential audit quality concerns. Ultimately, it is in our best interest and the interest of investors to promote full and effective communication between audit committees and audit firms, and this information would be useful in the audit committee's ongoing assessment of the audit firm's effectiveness. We also recommend that the PCAOB consider enhancements to the auditor's required communications to the audit committee that address additional matters specifically related to the audit firm's objectivity and professional skepticism exercised throughout the audit.

While the PCAOB has made progress in issuing their inspection reports more rapidly following the completion of inspection fieldwork, we encourage the PCAOB to continue to refine its reporting process so that inspection reports could be issued sooner after completion of fieldwork. For example, a recent inspection report for an annually inspected firm was issued in November 2011 following completion of fieldwork in November 2010, under which the covered audits were presumably for fiscal 2009 year-ends. We believe that a more timely delivery of the Board's inspection results to auditors and the investing public

following completion of fieldwork could provide important information to audit committees and further enhance ongoing efforts to increase audit quality.

In summary, we do not support a mandatory audit firm rotation requirement and believe the PCAOB should continue its research into other potential initiatives to improve auditor independence, objectivity and professional skepticism and, ultimately, audit quality.

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We appreciate the Board's consideration of these matters and welcome the opportunity to discuss any and all related matters. If you have any questions, please contact Lorraine Malonza at (973) 765-1047 or [lmalonza@financialexecutives.org](mailto:lmalonza@financialexecutives.org).

Sincerely,

A handwritten signature in cursive script that reads "Loretta Cangialosi".

Loretta V. Cangialosi  
Chair, Committee on Corporate Reporting  
Financial Executives International

cc: Martin F. Baumann, Chief Auditor and Director of Professional Standards



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January 30, 2012

Mr. J. Gordon Seymour  
Secretary, Public Company Accounting Oversight Board  
1666 K Street, NW  
Washington, DC. 20006-2803

PCAOB Rule Making Docket Matter No. 037 – Concept Release on Auditor  
Independence and Audit Firm Rotation

Dear Sirs:

In my capacity as a member of the Standing Advisory Group (SAG) and as the Chief Accounting Officer of Xerox Corporation I am pleased to have the opportunity to provide my comments and suggestions on the PCAOB's recent Concept Release "Auditor Independence and Audit Firm Rotation" (Release No. 2011-006). Xerox Corporation is a multinational organization with operations in 160 countries and annual revenues of approximately \$23 billion. Our audit fees, exclusive of non-recurring items and non audit services, have approximated \$20 million in recent years. We fully support the PCAOB's stated objectives for this Concept Release of strengthening auditor independence, objectivity and skepticism. These principles have long formed the basis of modern auditing and financial reporting and are critical to ensuring the integrity of an independent audit. However we at Xerox strongly disagree with any final rule making which will require the mandatory rotation of a company's auditors. We believe such a requirement will not result in improved auditor independence, objectivity or skepticism and there are numerous cost-beneficial ways, far short of auditor rotation, that can enhance achievement of these objectives. The PCAOB's own research and the research of others does not make a compelling case in support of mandatory auditor rotation. Further we note the Concept Release itself acknowledges that there are important company and investor benefits to long term audit relationships. Lastly, mandatory auditor rotation usurps a responsibility of a company's audit committee and will result in unnecessary costs and business disruptions. This letter will conclude with several suggestions on other means to potentially enhance auditor independence, objectivity and skepticism

My detailed comments and recommendations follow:

## Recent Enhancements to Auditing Standards Make Mandatory Auditor Rotation Unnecessary

The Sarbanes-Oxley Act has already resulted in significant enhancements to auditor independence and overall audit quality. The creation of the PCAOB with its audit firm registration process, deep inspection program and effective enforcement activities by itself represents a significant improvement from previous practice. As impressive as the PCAOB's activities and accomplishments have been to date, it is worth noting your organization is relatively young and the full positive impact of PCAOB activities is most likely still emerging.

Early in the PCAOB's existence the managerial reporting and external auditing on the effectiveness of internal controls over financial reporting (ICFR) became a reality for most corporations beginning in 2004. The positive impacts of ICFR are unmistakable. As reported in the Audit Analytics December 2011 report "Auditor Tenure, Financial Officer Turnover and Financial Reporting Trends" during the 6 years ended in 2010 material weaknesses in the Russell 1000 companies steadily dropped from 8.2% of companies in 2005 to 0.8% in 2010. Likewise for the same study group, in 2005 131 of the Russell 1000 companies reported restatements however that number had declined to 31 by 2010. Similar results are observed when the Russell 2000 companies results are included. The conclusion is that for 12,000 audits over the research period restatements and material weaknesses have steadily improved which must indicate that overall financial statement reliability has been improving.

In 2010 the PCAOB issued several new auditing standards on assessing engagement audit risk and, in 2009, a major standard expanding the role of the engagement quality reviewer (the 'EQR' or as more commonly known the concurring partner). Additionally, at this time there exists several important standards development projects which, when finalized, will undoubtedly increase auditor independence, objectivity and overall audit quality. These projects include the auditor's reporting model and auditor communications with audit committees among others.

One of the often expressed concerns about auditor independence (or lack thereof) is (was) the temptation for audit firms to actively solicit non audit services from audit clients such that the auditor may have become so financially dependent on non-audit fees, so much so that that audit independence, objectivity and skepticism were compromised. This important concern was also addressed by the PCAOB and SEC several years ago when nine (9) prohibited services by a company's auditor were enumerated. These significant restrictions on allowable non audit services has gone a long ways towards addressing the ability of auditing firms to become financially dependent on non-audit fees from audit clients. Proxy statement disclosures of fees paid to auditors is extensively studied and widely reported on. It is very apparent that

over the last decade non audit services provided to audit clients has been severely curtailed. In addition, many companies have adopted governance policies limiting non audit services to de-minimus amounts.

Lastly, we believe the current five year rotation requirement for the lead audit partner and the EQR effectively results in a ‘fresh look’ at the audit client every few years. In addition, for larger accounts the major audit firms have a practice of having a second headquarters audit partner assigned adding another check and balance on the lead audit partner. In comparison to earlier rules, after rotating off it is much more difficult for the lead audit partner to re-engage in the near term with his or her former audit client. The net result is that today a process is in place to continually ensure partner level transitions which can and does increase overall auditor objectivity and skepticism.

In light of all these impressive accomplishments – the benefits of some are just emerging - I recommend the Board refrain from the drastic step of mandatory auditor rotation until substantial evidence is available that conclusively establishes the aforementioned are materially ineffective.

#### Mandatory Auditor Rotation will Increase Risks to Audit Quality

While the stated objectives of this Concept Release are to enhance auditor objectivity, independence and skepticism these objectives represent tactical goals in support of the Board’s overarching objective which is to improve overall audit quality. We believe that mandatory rotation of auditing firms will most likely result in lower – not higher – overall audit quality.

Institutional knowledge is a valuable asset – one that is not capable of being sold or transferred from one entity to another. It is obtained the old fashioned way – by the sustained hard work of many professionals over a long period of time. One of the primary reasons a company, or more importantly its audit committee, values long term audit relationships is this institutional knowledge as it enables the auditor to bring the proper resources to the audit at the right place and time. Learning curves are steep and costly. The Concept Release itself notes that most audit failures occur early in a new auditor’s tenure. There is a big difference between a new auditor having the minimum knowledge of a company and its control environment required to conduct an audit in accordance with the standards of the PCAOB and an effective audit which is planned and executed by an incumbent auditor with full knowledge of the company, its financial processes, culture, business objectives, etc.

With respect to transitioning institutional knowledge, there is an enormous difference between a lead partner or engagement team within a firm transitioning audit knowledge to another audit partner in the firm versus the information that is required to be communicate between predecessor and successor audits under



current standards. It seems very logical that within a firm there will be an orderly and effective transition policy and protocol versus what may be expected between different audit firms. We believe the current practices of mandatory partner rotation, EQR reviews and National Office reviews and consultations are sufficient to preserve auditor independence, objectivity and skepticism. If, despite many objections to the contrary, the Board decides to require mandatory auditor rotation, as a prerequisite the Board will need to vet new standards with respect to required communications and transitional support between predecessor and successor auditors.

Audit services for multinational corporations can rarely be met other than a Big 4 firm. It is important to note that the Big 4 are not fungible. They each have varying strengths (and weaknesses) in terms of geographic reach, industry expertise, local presence, etc. It is possible in a given industry that only 2 of the Big 4 have the relevant firm wide expertise. In this scenario the situation would effectively result in a duopoly and industry participants would merely rotate back and forth between 2 firms. Does this accomplish much?

One last point on audit quality and risk, while most observers seem to agree the risk of audit failure is highest in the early years of a new auditor's tenure, I submit there is an equal risk of audit failure late in the auditor's tenure as well because the existing audit firm can naturally be expected to move its best people assigned to the audit to other clients of the firm.

#### Appointment and Removal of Auditors is Properly an Audit Committee Responsibility

Under Section 301 of the Sarbanes-Oxley Act, the audit committee of a public company is responsible for managing the relationship with the company's independent auditor including appointment, compensation, retention and oversight. Mandating auditor rotation would circumvent this external director governance responsibility and compromise the audit committee's ability to effectively engage, oversee and terminate an audit firm. For U.S. public companies, all audit committee members must be independent directors who are knowledgeable about a company's business, internal controls, financial policies and external reporting requirements. Because of this unique role, we believe a company's audit committee is best positioned to determine the circumstances under which an incumbent audit firm should be replaced. It is important that an effective working relationship exists between a company's audit firm and the audit committee; the requirement for periodic rotation is inconsistent with this objective. Audit committees do have the right to terminate an audit relationship at any time deemed appropriate and, as is public record, it is not infrequent that this right is exercised. When an audit termination occurs, SEC has Form 8-K disclosure requirements requiring both the company and the terminated firm to report on the circumstances of the dismissal.

Assuming the PCAOB persists, despite the strong objections of many commentators, to require mandatory auditor rotation there will inevitably be many instances where a change in auditors compelled by regulation would not be in the interest of the company or its investors and such a change would not be otherwise contemplated. For example, a very complex M&A transaction, a major business re-organization or transformation, a material capital markets action, etc. may span several quarters and be in process over a fiscal year end when there is a change in the external audit firm before the event in question is finalized. This will create significant challenges for, and between, management, the predecessor auditor and the successor auditor and require complicated and otherwise unnecessary coordination of activities. The list of potential complications is long but includes the obtaining of consents, subsequent events reviews by the predecessor auditor, carrying forward prior year audit reports on earlier year but still live financial statements, concurrence between the two auditing firms on all material matters of accounting and auditing significance, etc. We strongly encourage the Board to field test and evaluate the real world implications of requiring the rotation of audit firms at sub optimal times and the difficult position audit committee members will find themselves in these circumstances.

#### Mandatory Auditor Rotation will Permanently Increase Costs and Result in Unnecessary Business Disruption without Commensurate Benefits

Virtually all comment letters have noted the significant increase in audit costs that mandatory auditor rotation will cause. We agree with those observation and would like to offer some additional perspectives which have not been as frequently raised in the comment letters to date:

Monetary amounts aside, the PCAOB needs to address the question, and concern, as to exactly how the audit firms will source the increased workload? I have been on both sides of changing auditors both as an auditor and as a preparer. Many commenters have observed that it is at least four (4) years into a new audit engagement before the audit effort settles into its ongoing level. Consider this plausible scenario: In year 1 of a new audit there is a 50% increase in assigned hours over the steady state; in year two - 30% and year 3 - 10% before year 4 achieves normal go forward level of efforts. Extrapolating this using the European Union proposal of a 6 year rotation plan, there is a 15% permanent increase in audit hours so presumably on average each auditing firm will need 15% more staff. Extrapolating using a 10 year rotation plan results in 9% permanent increase in staffing requirements. With respect to the demand for accounting skills, every analysis I have seen indicates that the demand for accounting talent will grow by ~5% or more for the foreseeable future. So, the obvious question in need of an answer is 'where will all these future accountants come from?'

There will be significant burdens and hidden costs with respect to the rotational selection process itself – on management, the audit committee and the audit firms. The process for changing auditors, similar to the process for changing other major vendors, would commonly use an RFP process. Due diligence materials would need to be prepared; interviews with prospective auditors would need to occur; the audit firms would need to consider their bids and identify the engagement partner and senior audit team. For a multinational corporation the size of Xerox this process would be lengthy - the mere task of visiting numerous global locations and obtaining an understanding of accounting processes and internal control effectiveness would be immense and expensive. Senior management and the audit committee would need to divert significant time to reviewing and assessing competing bids and final interviews. After the new firm was selected, there would then need to be a major coordinating effort between the predecessor and successor firms. The company's internal accounting and other finance organizations would see an exponential increase in staff time to adopt to a new auditing firm and to familiarize the new auditors with the company. All of this unnecessarily drives up operating costs and diverts important managerial and outside director time for no commensurate benefit.

For virtually all major corporations, realistically only the Big 4 firms can perform the audit. Xerox, like most major companies, routinely utilizes the consulting and other non-audit services capabilities of the remaining Big 4 firms. Many of these services would constitute prohibited services if performed by our external auditors. Further, even if not an expressly prohibited service, many companies from time to time will use these same firms to perform other non-audit and consulting services which current governance practices would tend not to award to a company's audit firm. The Big 4 firms have immense global presence and vast business support capabilities. Mandatory audit rotation would be a disservice to investors because one of the practical implications is that the at least some non-audit service capabilities of the other Big 4 firms would no longer be available to companies.

Multinational companies globally operate through subsidiaries most of which will have statutory audit requirements. It is not uncommon for corporations the size of Xerox to have hundreds of statutory audit reports each year. For purposes of the US GAAP and GAAS audit only a handful would typically be significant with the remainder being primarily local compliance efforts. Many companies have a policy of requiring all statutory audits to be performed by the parent company's auditor. In order to minimize business disruption, companies would have to choose – leave the local incumbent statutory auditors in place when the parent company rotates the incumbent Big 4 auditor or transition dozens to hundreds of local audits to the new Big 4 firm which may not otherwise be necessary to enable the US GAAP and GAAS audit. As the PCAOB deliberates the notion of mandatory auditor rotation the implications on statutory audits should not be underestimated.

### Evidence in Support of Mandatory Auditor Rotation is Neither Sufficient nor Compelling

The Concept Release accurately notes that the issue about mandatory auditor rotation has been around for a long time and I agree it is time to conclusively address the subject and (presumably) conclude the costs and risks far outweigh the benefits. Many comment letters have noted the conclusion of the 2003 GAO Report, commissioned as part of the Sarbanes-Oxley Act, to study and report on the potential effects of requiring mandatory audit firm rotation. The conclusion, as you are aware, states that “mandatory audit firm rotation may not be the most efficient way to enhance auditor independence and audit quality.”

It does not appear staff or other independent research to date has established a definitive correlation between audit failures and the length of the audit relationship. It is important to observe that the Board defines audit failures as situations where documented audit evidence is either insufficient, or categorically does not, provide the proper support the audit report. Financial statement users on the other hand would likely define audit failures in terms of restatements which, as discussed on page 2 of this letter, are infrequent and declining. It is critical for this project to reconcile these two very different theories.

I recommend that staff research on the incident rates of audit failures be conducted to categorize the nature of audit failures by: auditor competence and training, lack of industry expertise; occurring in the early years of a new audit relationship; audit firm size no longer adequate for a growing client; and lastly by lack of auditor independence, objectivity or skepticism. Lastly, this research should not be limited to audits supervised by the PCAOB – it is only in the last year that the PCAOB (as part of the Dodd Frank Act) achieved control over the audits of broker-dealers and as we all know too well some of the most spectacular audit failures in recent years (e.g. Madoff Securities) involved audits not subject to the PCAOB’s procedures.

### Potential Strategies for Enhancing Auditor Independence, Objectivity and Skepticism

The considerable Board and staff effort which would be required to attempt finalizing a rule requiring mandatory auditor rotation would be far better used in developing new auditing standards and other policy positions consistent with the Concept Release’s primary objective of enhancing auditor independence, objectivity and skepticism. I believe considerable progress can be made towards the objective in a much more cost-beneficial and practical manner than the draconian step of requiring mandatory auditor rotation. I have listed below a number of suggestions for your consideration:

- The PCAOB should refine its inspection process such that its firm inspection reports are issued more timely. For example, in November of 2011 an inspection report of a major firm was issued for field work completed in November 2010 for the calendar year 2009 audits. Using this example, by the time the year end 2011 audits are completed, fully 40% of the engagement partners from the 2009 audits will have rotated off the engagement diminishing the effectiveness of the inspection findings. A more timely delivery of inspection results to the investing public would be beneficial.
- PCAOB inspection reports for the specific engagements reviewed should be made available to the audit committees of the companies audited. Many comment letters have recommended this. Transparency is always key to effectiveness as the 'light of day' (or the potential therefore) tends to bring out the best in people – in this case an audit engagement partner would clearly not want it to be communicated to his or her client that the PCAOB had concerns with how the engagement was conducted. We want to second the comment letters from many audit committee members who have also recommended these reports be made available because an inspection report would be invaluable to the audit committee's oversight of the audit function.
- Several professional groups I am associated with have discussed the merits of revising audit committee membership requirements to include a 'financial accounting' or 'financial auditing' expert – which is a different skill set from today's required 'financial expert'. This letter is not advocating this becomes a requirement but merely that the subject is worthy of PCAOB and SEC staff research.
- At several SAG meetings we have discussed 'audit quality indicators' – what they are, how they would be measured and how they would be used. To my knowledge no consequential further actions have to date occurred. I recommend this become a formal staff project and when finalized they become a part of the PCAOB inspection procedures and, to the extent any inspection report is engagement specific, it be shared with the related audit committee.
- Finalize the current major PCAOB projects on revising the auditor's reporting model and required communications with audit committees and allow sufficient time for these standards to be in force and then measure their effectiveness. While many commenters, including as you will recall myself, disagreed with many of the more expansive requirements of these proposals I anticipate that both projects will be completed with at least some modification from current requirements. These should be allowed reasonable time to work in practice and their effectiveness evaluated.
- Finalize the requirement to publicly disclose the name of the lead engagement partner – either by a personal signature on the audit report or by other disclosure means. This issue has been discussed many times at SAG and other PCAOB forums and is a common practice outside the

United States. Publicly personalizing the engagement partner's name with the audit report and related annual report can only serve to increase the engagement partner's focus on the quality of the audit.

Summary

We strongly disagree with any notion of requiring mandatory audit firm rotation no matter what the rotational interval may be. Such a requirement holds a very real possibility for an overall decrease in audit quality and will result in a permanent increase in cost and business complexity that is not justified by the evidence at hand. As discussed, the numerous PCAOB and SEC pronouncements and regulations of recent years are having a positive effect on external reporting casting further doubt on the need to mandate auditor rotation. We remain very supportive of the Board's efforts to continue enhancing auditor independence, objectivity and skepticism by less draconian, more cost effective means and, as we have in the past, are prepared to provide the Board whatever assistance we can.

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Thank you for the opportunity to provide these comments for your consideration on this important project. Please do not hesitate to contact me if you have any questions or comments about the contents of this letter.

Yours very truly,



Gary R. Kabureck

c: M. Baumann, Chief Auditor and Director of Professional Standards, PCAOB