February 14, 2014

Dr. Martha Carter
Chair
Global Policy Board
Institutional Shareholder Services
2099 Gaither Road
Rockville, MD 20850-4045

Re: ISS Benchmark Policy Consultation: Auditor Ratification (U.S.)

Dear Dr. Carter:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants.

The CAQ welcomes the opportunity to comment on the Institutional Shareholder Services' (ISS) *Benchmark Policy Consultation document on Auditor Ratification (U.S.)* (the Consultation). This letter represents the observations of the CAQ, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

Over the past three years, the CAQ has publicly shared its perspectives on ways to enhance auditor independence, objectivity, and professional skepticism, particularly through comment letters submitted to the U.S. Public Company Accounting Oversight Board (PCAOB or the Board) and the U.K. Financial Reporting Council (FRC).[1] In those letters, we have consistently shared our belief that there is no nexus between auditor tenure and auditor independence, objectivity or professional skepticism; moreover, we believe that the rotation of auditors based primarily, or solely, on auditor tenure would undermine the responsibilities of the audit committee to evaluate the auditor and determine whether to replace or retain the auditor.

While we appreciate ISS's interest in expanding the factors that may be relevant to its proxy voting recommendation, we do not believe that ISS should change its proxy voting benchmark policy on auditor ratification to include auditor tenure as a critical factor to consider when evaluating the proposal to ratify auditors.

[1] See CAQ comment letters to the PCAOB dated December 11, 2013 (link) and December 14, 2011 (link) and the FRC dated July 13, 2012 (link).

No Indication That Longer Auditor Tenure Impairs Independence

The Sarbanes-Oxley Act of 2002 (SOX) was enacted to strengthen auditor independence and to improve audit quality. SOX established the PCAOB and gave it the primary responsibility to oversee the audits of public companies; establish standards and rules related to the preparation of audit reports for public companies; and investigate, inspect, and enforce compliance with these rules.

During the congressional hearings that preceded the enactment of SOX, mandatory audit firm rotation (MFR) – that is, setting a limit on the number of years an auditing firm may audit a particular company's financial statements – was considered as a potential reform to enhance auditor independence and audit quality. However, Congress concluded that MFR needed further evaluation and directed the U.S. Government Accountability Office (GAO) to study the potential effects of requiring rotation of firms that audit public companies registered with the U.S. Securities and Exchange Commission (SEC).[2]

In its November 2003 report, the GAO determined that MFR may not be the most efficient way to strengthen auditor independence and improve audit quality. The reasons cited for this conclusion included the additional financial costs, the loss of institutional knowledge of the public company's previous auditor of record, and the independence and other reforms that were being implemented by companies, audit committees and the audit firms at that time to comply with SOX. The GAO report added that several years of experience with implementation of SOX was needed before the full effect of SOX requirements could be assessed. The GAO recommended that the SEC and PCAOB monitor and evaluate the effectiveness of existing requirements for enhancing auditor independence and audit quality.

In June 2011, the PCAOB issued a concept release[3] that analyzed and described potential ways to enhance auditor independence, objectivity, and professional skepticism, including through MFR. The PCAOB's concept release acknowledged that the Board had been unable to demonstrate that objectivity and professional skepticism are impaired by the tenure of the audit engagement. The CAQ, in its comment letter to the PCAOB, highlighted that we were unaware of any credible empirical research demonstrating that longer audit firm tenure impairs auditor independence, objectivity, or professional skepticism. To the contrary, numerous academic studies suggested that audit quality improves on longer tenured audits.[4]

In total, the PCAOB received almost 700 comment letters and over 90% of the commenters, including the majority of investors, opposed MFR. According to PCAOB chairman, James Doty, the vast majority of commenters urged the Board to take additional time to perform more studies in order to develop more modest reform.[5] More recently, in August 2013, the PCAOB issued a proposal to update and enhance the auditor's reporting model; and again, acknowledged that "the Board has not reached a conclusion regarding the relationship between audit quality and auditor tenure."[6]

In July 2013, the U.S. House of Representatives voted to amend[7] SOX, to expressly deny the PCAOB any authority to require that public company audits be conducted by different auditing firms on a rotating basis. The bill also directed the GAO to update its November 2003 report to include, among other things, an updated study on whether mandatory rotation of registered accounting firms would mitigate conflicts of interest between registered public accounting firms and issuers. The action taken by Congress and the directive given to the GAO indicate clear reservations about the lack of evidence connecting auditor tenure to

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2 See the GAO's Required Study on the Potential Effects of Mandatory Audit Firm Rotation (link).

3 See the PCAOB's Concept Release (link).

4 See, *Auditor Tenure and Perceptions of Audit Quality,* The Accounting Review, Vol. 8, No. 2. Ghosh and Moon (2005); *Auditor Tenure and Auditor Change: Does Mandatory Auditor Rotation Really Improve Audit Quality?* Mara Cameran, Annalisa Prencipe, and Marco Trombetta (Working Paper 2008); *Mandatory Audit Firm Rotation and Audit Quality*, Andrew B. Jackson, Michael Moldrich, and Peter Roebuck (July 2007).

5 James R. Doty, PCAOB Chairman, "Auditor Independence and Audit Firm Rotation" (speech, Houston, TX, October 18, 2012) (link).

6 PCAOB Proposed Auditing Standard on *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, page A5-16 (link).

7 "H.R. 1564--113th Congress: Audit Integrity and Job Protection Act." (link).

independence, or other potential conflicts of interest with companies. Academic, public policy and regulatory officials have been unable to demonstrate a clear correlation between auditor tenure, and auditor independence and quality; thus, we believe ISS' inclusion of auditor tenure as an auditor ratification benchmark would create the false impression that such a correlation exists and could have unintended consequences on audit quality and the audit committee's oversight of the independent auditor.

<u>The Audit Committee's Responsibility for Auditor Oversight</u>

As noted above, SOX charged audit committees with the responsibility to appoint, compensate, and oversee the work of the auditor.[8] We believe that this has been a critical reform and has served to enhance auditor independence. We are concerned that ISS' inclusion of auditor tenure as a critical evaluation factor for auditor ratification could ultimately lead to the rotation of auditors based solely, or primarily, on auditor tenure which would result in any number of unintended consequences and undermine the responsibilities of the audit committee. The audit committee is in the best position to weigh a myriad of factors regarding the auditor and the company, and to make the recommendation to the board and shareholders whether to retain the audit firm or retender the audit.

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We believe that ISS should not change its proxy voting benchmark policy on auditor ratification to include auditor tenure as a critical evaluation factor for auditor ratification, and we strongly urge ISS to carefully consider the comprehensive body of research and thoughtful commentary that exists on the subject of auditor tenure before taking further action on amending its related proxy voting recommendation policies.

The CAQ appreciates the opportunity to comment on the Consultation and we would be pleased to discuss our comments or answer any questions that ISS Global Policy Board or staff may have regarding the views expressed in this letter.

Sincerely,

Cynthia M. Fornelli

Cynthia M. Fornelli
Executive Director
Center for Audit Quality

[8] When legal or security exchange listing requirements require or permit shareholders to vote on, approve, or ratify auditor appointment and compensation, the audit committee is responsible for making such recommendations or nominations.