



1401 H Street, NW, Washington, DC 20005-2148, USA
202/326-5800 www.ici.org

December 14, 2011

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

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

Dear Mr. Seymour:

The Investment Company Institute¹ appreciates the opportunity to comment on the PCAOB's Concept Release on Auditor Independence and Audit Firm Rotation.² The Institute supports the Board's mission to oversee the audits of public companies and to protect the interests of investors through the preparation of informative, accurate and independent audit reports. We commend the Board for seeking public comment on ways that auditor independence, objectivity and professional skepticism could be enhanced. Indeed we encourage the Board to "step back" from time to time and consider whether its audit standards, inspection programs, and enforcement actions are working as intended to ensure that audits provide investors with reasonable assurance that the financial statements on which they rely are free of material misstatement.

We have serious concerns, however, with the Release and we strongly oppose mandatory audit firm rotation. We believe the Release fails to provide sufficient evidence of audit failures attributable to a lack of objectivity and professional skepticism that would justify Board consideration of mandatory audit firm rotation. Indeed, we believe the Board's oversight of public company audits since its formation in 2002 has substantially improved audit quality. We are concerned that mandatory audit firm rotation would diminish audit quality in the first several years of the engagement, as the auditor

¹ The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$12.5 trillion and serve over 90 million shareholders.

² Concept Release on Auditor Independence and Audit Firm Rotation, PCAOB Release No. 2011-06 (August 16, 2011) (the "Release").

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learns the client's business. We believe the auditor would necessarily increase its fees during this period to recover the cost of the additional hours required on the engagement. We are also concerned that industry-specific factors may limit audit committee choice in selecting a new auditor if mandatory audit firm rotation were to be required.

We recommend that the Board address any deficiencies in objectivity and professional skepticism through its standard-setting, inspection, and enforcement programs, rather than through mandatory audit firm rotation. Our comments are from the perspective of investment companies as issuers of financial statements.

Audit Failures

The Release indicates that the Board has, since its creation, conducted hundreds of inspections of registered public accounting firms each year and that the Board regularly finds instances in which it appears that auditors did not approach some aspect of the audit with the required independence, objectivity and professional skepticism. According to the Release, the Board's inspectors have discovered "several hundred" cases involving what they determined to be audit failures. An audit failure in this context is an audit opinion that, when issued, was not supported by sufficient appropriate evidence.

Audit failure, as defined in the Release, does not mean that the financial statements were materially misstated or failed to comply with GAAP. Instead, audit failure means that the Board's staff identified a deficiency in the audit process. We cannot help but wonder what proportion of these failures was attributable to factors other than a lack of professional skepticism. For example, were they due to disagreements between the Board's staff and the auditor over interpretation or application of accounting or auditing standards? Were they due to disagreements over what constituted sufficient evidence in the circumstances? We do not mean to minimize the importance of the failures noted in the Release. Indeed, we encourage the Board to rigorously enforce its standards whenever it finds audit failures. We believe, however, that the Board has not conclusively tied these failures to a lack of professional skepticism. We encourage the Board to continue its efforts to identify the root causes of audit failures so that it may address them through enhancements to its auditing standards.

We also wonder what proportion of the audit failures cited in the Release relates to SEC registered investment companies. Fund financial statements are inherently less complex than operating company financial statements due to the limited nature of the fund's operations (*i.e.*, issuing shares and investing the proceeds in a portfolio of securities). The limited nature of fund operations results in audits that are less complex than audits of operating company financial statements. As a result, we believe there is less opportunity for management to inappropriately influence or pressure the auditor to accept its judgments. The Board itself has acknowledged that audits of investment companies are less

complex than audits of operating companies.³ The Board should conclusively link audit failures to a lack of professional skepticism generally, and more specifically establish such link in the fund industry, before it applies any mandatory rotation requirement to investment companies.

Existing Mechanisms to Ensure Professional Skepticism

Those in favor of mandatory audit firm rotation typically indicate that it would strengthen the auditor's ability to resist management pressure. Those in favor of rotation also believe that an auditor that knows its work will be scrutinized at some point by a competitor may have an increased incentive to ensure that the audit is done correctly. As the Board well knows, there are a number of mechanisms currently in place that are intended to empower the auditor to resist management pressure and ensure that the audit is performed in compliance with professional standards. These mechanisms include:

- 1) Oversight by the issuer's audit committee, which is comprised entirely of independent directors, and includes an audit committee financial expert;
- 2) Concurring partner review of the engagement;
- 3) Rotation of both the lead engagement partner and the concurring partner after five years;
- 4) Mandatory quality control systems;
- 5) The Board's inspection and enforcement programs; and,
- 6) The threat of litigation for failed audits (*i.e.*, financial statements contain material misstatements).

We understand that the quality control systems referred to above must be designed to provide the audit firm with reasonable assurance that its personnel are performing audits in compliance with applicable professional standards, including those relating to independence, objectivity, and professional skepticism. Further, that these quality control systems must entail a monitoring element whereby dedicated audit firm staff perform inspections of audits conducted by the firm's personnel. We understand that the findings from these "internal inspections" of audits can significantly influence opportunity for professional advancement within the firm, providing further incentive for audit staff to conduct the engagement in a manner consistent with professional standards.

Pending Enhancements to Audit Standards

Over the past two years the Board has adopted significant enhancements to its audit standards. In particular, in July 2009 the Board adopted Audit Standard No. 7, *Engagement Quality Review*, which provides a framework for concurring or second partner evaluation of the significant judgments made and related conclusions reached by the audit engagement team. The standard focuses the concurring

³ The Board and the FASB are funded through "accounting support fees" paid by public companies and based on their market capitalization. Investment companies pay accounting support fees at a rate equal to 10% of the rate paid by operating companies. When adopting the 10% fee rate structure applicable to investment companies, the Board recognized the relatively less-complex nature of investment company audits. *See* PCAOB Release No. 2003-003 (April 18, 2003).

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partner's attention on areas that are most likely to contain significant deficiencies and correcting those deficiencies before the audit report is issued. AS No. 7 is effective for fiscal years beginning on or after December 15, 2009.

In August 2010 the Board adopted a suite of eight auditing standards relating to the auditor's assessment of, and response to, risk in a financial statement audit. The new suite of audit standards promotes sophisticated risk assessment in audits and minimizes the risk that the auditor will fail to detect material misstatements. The standards address audit procedures performed throughout the audit, from initial planning through the evaluation of audit results. The standards are effective for fiscal years beginning on or after December 15, 2010.

The inspection results and audit failures described in the Release relate to periods that precede these recently adopted standards. We expect that these audit standards will improve audit quality going forward and encourage the Board, through its inspection program, to evaluate their effect on auditor performance.

Disruption

Mandatory audit firm rotation will require company personnel responsible for financial reporting, to devote significant time and resources to assist the new auditor in learning about the company's business, systems, and control environment. Investment companies frequently hire third party service providers, such as a custodian to hold the fund's securities, and a transfer agent to maintain shareholder account records. The new auditor would also need to familiarize itself with the operations and controls of these service providers.

Audit Quality

We are concerned that the new auditor's lack of knowledge of the company's business, systems, control environment, and financial reporting practices increase the risk that the auditor will not detect financial reporting issues that could materially affect the company's financial statements during the initial years of the new auditor's tenure. We also have concerns audit firms would, under mandatory rotation, move their most knowledgeable and experienced personnel from the current audit to other audits as the end of their tenure approached, in order to attract or retain other clients. In other words, if the audit firm knows that its relationship with the client will sunset, it must necessarily focus on obtaining new clients. Ironically, audit firm rotation may diminish audit quality and increase the risk of material misstatement due to the loss of institutional knowledge the incumbent auditor brings to the engagement, and the learning curve the new auditor must climb.

Increased Cost

Audit standards require the auditor to obtain a level of knowledge of the company's business, systems, and controls that will enable him to plan and perform the audit. That level of knowledge

should enable him to obtain an understanding of the events, transactions, and practices that may have a significant effect on the financial statements. The new auditor must necessarily build additional hours into the engagement in order to become familiar with the company's business, systems, and controls so that he can properly determine the scope of the audit and the nature and extent of substantive tests to be performed. In a recent survey, large audit firms estimated that initial year audit costs under mandatory audit firm rotation would increase by more than 20% over subsequent year costs in order to acquire the necessary knowledge to perform the audit.⁴ For open-end mutual funds, these costs would be borne by shareholders in the form of increased fund expenses and diminished returns.

Investment Company Industry Background

Investment companies pool investor funds in order to provide shareholders with professional investment management. Typically an investment company sells its capital shares to the public and invests the proceeds entirely in securities consistent with its stated investment objectives and policies. Often an investment adviser will sponsor several different funds, each pursuing a different investment objective (*e.g.*, growth, income, capital preservation) or providing access to different asset classes (*e.g.*, equities, fixed-income, money market securities). These several different funds managed by the same adviser may be referred to as a "complex" or "family of funds." Larger fund complexes will typically set the fiscal year ends for its funds throughout the year, so as to spread the associated work load. In these instances, the independent accountant is conducting audits throughout the year.

Investment companies typically have no employees. Instead, their operations are conducted by various affiliated organizations and independent contractors, such as an investment adviser, administrator, underwriter, custodian, and transfer agent. As is the case for other types of companies, fund directors have oversight responsibility for the management of the fund's business affairs. Often all funds in the complex will be overseen by one board of directors. In other instances, the complex may have two or more boards comprised of different individuals, with each board overseeing a different group of funds.

Mutual funds are widely offered as investment vehicles in defined contribution retirement plans. According to Institute data, Americans held \$4.7 trillion in all employer-based defined contribution retirement plans on June 30, 2011, of which \$3.2 trillion was held in 401(k) plans. Mutual funds managed \$2.6 trillion, or 56 percent, of assets held in 401(k), 403(b), and other defined contribution plans at the end of June.

Institute data show that approximately 94% of all mutual funds are audited by one of the "big 4" audit firms and that these funds represent about 99% of industry assets. Audit firms that perform mutual fund audits typically have personnel dedicated to the asset management industry who are familiar with the industry specific accounting model required by FASB Topic 946, the special tax status

⁴ U.S. General Accounting Office, Required Study on the Potential Effects of Mandatory Audit Firm Rotation (November, 2003).

afforded funds under Subchapter M of the Internal Revenue Code, and the overlay of Investment Company Act of 1940 regulation (“1940 Act”).

Investment Company Considerations

There are several factors specific to the investment company industry that may limit audit committee choice in selecting a new auditor.

If a particular fund family’s funds are offered through an audit firm’s 401(k) retirement plan to the audit firm’s employees, then that audit firm likely would not be willing to audit funds in the fund family because of the independence issues it would raise.⁵ The audit firm could, for example, cause its employees (and their immediate family members) to sell their investments in the fund family’s funds in order to cure the independence problem. We believe, however, that the audit firm would be unlikely to do so because of the disruption it would cause its employees and their retirement planning. We understand that the audit firms have identified certain fund families which they will not audit, so as to ensure funds from these families are available to their employees for investment through the audit firm’s 401(k) plan. Audit firm personnel may also hold investments in the fund family’s funds outside tax-deferred accounts and any forced divestment could impose significant tax consequences on those personnel.

An auditor to an investment company must be independent with respect to the fund, and also the investment company complex. The term “investment company complex” as defined in the SEC’s independence rules includes the fund’s adviser, any investment company managed by the adviser, other pooled investment vehicles managed by the adviser that would be an investment company but for the exclusions provided by Section 3(c) of the 1940 Act (*e.g.*, private funds), any entity that controls the adviser, any entity that the adviser controls, and any entity under common control with the adviser that either 1) is an investment adviser, or 2) is in the business of providing administrative, custody, transfer agency, or underwriting services to any investment company.⁶ Generally speaking, the investment company complex means the fund operation in its entirety, including all the funds, the adviser, its ultimate parent company, and any subsidiaries of the parent company that are engaged in the investment company business.

Where the adviser to an investment company is part of a broader financial services organization (*e.g.*, a bank or insurance company), decisions made at the ultimate parent level can also affect the independence of the fund’s auditor and would limit audit committee choice under mandatory audit firm rotation. For example, consider a global financial services organization that owns an investment

⁵ We recognize the concept of “covered person” within rule 2-01 of Regulation S-X affords employees not associated with the engagement, in the engagement office, or in the chain of command to invest in the funds. We understand, however, that audit firms may adopt more restrictive policies that prohibit all employees from investing in the funds.

⁶ Rule 2-01(f)(14) of Regulation S-X.

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adviser that manages a family of funds. Any audit firm that provides prohibited non-audit services to the global parent organization would not be independent with respect to the funds. That audit firm may decide that the consulting services are more valuable to the firm than the professional fees associated with auditing the funds.

Recommendations

We believe that the audit reforms implemented since 2002 combined with the Board's inspection and enforcement programs have significantly improved public company audits. If the Board can demonstrate the need to further enhance independence, objectivity and professional skepticism, we recommend that it do so through its standard setting, inspection, and enforcement programs, rather than through mandatory audit firm rotation.

Standard setting could consider, for example: 1) a requirement for the audit firm to provide the audit committee with the Board's most recent inspection report on the audit firm; 2) if the issuer's audit was selected for inspection by the Board, a requirement for the audit firm to provide the audit committee with the Board's findings and recommendations, and any remedial actions taken by the audit firm; and, 3) a requirement for the audit firm to provide the audit committee annually a written report describing the firm's internal quality-control procedures, any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues. We understand that audit committees for exchange listed companies currently receive and review the report described in our third recommendation. Audit committees for public companies not listed on an exchange, such as mutual funds, however, are not currently required to receive this report.

If you have any questions on our comments or require additional information, please contact the undersigned at 202/326-5851.

Sincerely,

Gregory M. Smith

Gregory M. Smith
Director – Fund Accounting
Investment Company Institute

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cc: James R. Doty, PCAOB Chairman
Lewis H. Ferguson, PCAOB Board Member
Daniel L. Goelzer, PCAOB Board Member
Jay D. Hanson, PCAOB Board Member
Steven B. Harris, PCAOB Board Member

Jaime Eichen, Chief Accountant
Division of Investment Management
U.S. Securities and Exchange Commission