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December 14, 2011

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

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

Dear Mr. Seymour:

The Independent Directors Council¹ appreciates the opportunity to comment on the Public Company Accounting Oversight Board's concept release on auditor independence and audit firm rotation.² The Release—in particular, the request for comment on mandatory audit firm rotation—raises a number of issues and concerns for companies, accounting firms, and company boards. Investment company (“fund”) directors³ oversee the management and operation of funds on behalf of over 90 million shareholders and present a unique perspective on the fund regulatory framework and the protections it provides to investors, including those relating to the audit function. IDC's letter focuses on mandatory audit firm rotations and the adverse impact they would have on funds and their boards and shareholders.

¹ IDC serves the fund independent director community by advancing the education, communication, and policy positions of fund independent directors, and promoting public understanding of their role. IDC's activities are led by a Governing Council of independent directors of Investment Company Institute member funds. ICI is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. Members of ICI manage total assets of \$12.5 trillion and serve over 90 million shareholders, and there are almost 1,900 independent directors of ICI-member funds. The views expressed by IDC in this letter do not purport to reflect the views of all fund independent directors.

² See [Concept Release on Auditor Independence and Audit Firm Rotation](#); PCAOB Release No. 2011-006 (August 16, 2011) (“Release”).

³ An investment company may be organized as a corporation, with a board of directors, or as a business trust, with a board of trustees. This letter's references to “fund directors” refer to both directors and trustees of registered investment companies.

The role of independent directors with regard to the fund's auditor is clearly defined by the Investment Company Act of 1940 ("1940 Act") and the rules thereunder. Specifically, the statute requires independent directors to select the fund's auditor.⁴ Funds are exempt from seeking shareholder ratification for the selection of the auditor if, among other things, the fund's board has an audit committee composed solely of independent directors. This framework highlights the importance of both the audit function and the role of fund independent directors, as the selection of a fund's auditor is one of only four responsibilities specifically assigned by the 1940 Act to fund independent directors.

IDC appreciates the PCAOB's focus on auditor independence, objectivity, and professional skepticism. We agree that the integrity of the audit process depends on independent and expert auditors, but an audit firm rotation requirement is not necessary to achieve this goal and, in fact, could detract from it. There is no clear correlation between any audit deficiencies and a lack of auditor independence. Likewise, we are not aware of, nor has the PCAOB demonstrated, any problems with respect to auditor independence relating to funds that would warrant such a draconian requirement. As discussed below, mandatory audit firm rotations could, to the detriment of fund shareholders, increase the cost of audits and diminish the quality of them. With no basis for the mandate, and in light of the negative consequences, an audit firm rotation requirement would be a costly and disruptive solution in search of a problem.

IDC believes that the substantial burdens, risks, and costs for funds of a mandatory audit firm rotation requirement would far outweigh any benefits. Accordingly, we oppose such a mandate. We do, however, recognize the benefits of continuously working to improve the quality of audits. In that regard, we encourage the PCAOB to study ways to improve its communications with and education of audit committee members.

Existing Safeguards in the Fund Industry Promote the Integrity of Fund Audits

We firmly believe, and history has shown, that existing safeguards are more than adequate to assure the independence of auditors. In addition, we contend that the premise of the Release—that audit deficiencies are attributable to a lack of auditor independence—is not applicable to funds. The Release does not cite to any deficiencies in fund audits, nor are we aware of any such deficiencies.

The 1940 Act and SEC rules have long required funds to have strong systems of controls and procedures in place to protect investors and to ensure the integrity of financial statements. The Sarbanes-Oxley Act of 2002 bolstered these protections.⁵ As the Release notes, in 2003, the SEC, in

⁴ Section 32 of the 1940 Act.

⁵ We note that the SEC's Chief Accountant recently expressed his belief that "auditor performance and the reliability of financial reporting have improved significantly in the past decade." Speech by James L. Kroeker, SEC Chief Accountant, [Remarks Before the 2011 AICPA National Conference on Current SEC and PCAOB Developments](#) (December 5, 2011).

implementing various sections of Sarbanes-Oxley, adopted a variety of rules designed to strengthen auditor independence.⁶ For instance, the rules expand the types of non-audit services that, if provided to an audit client, would impair an audit firm's independence. The rules also establish a "cooling off" period before a member of the audit engagement team could work at the audit client. Most notably, though, the rules impose rotation requirements for lead audit partners and concurring review partners.

In adopting these reforms, the SEC worked to "strike a balance between the need to achieve a fresh look on the engagement and a need for the audit engagement team to be composed of competent accountants."⁷ We agree with the SEC's balanced approach and believe that requiring the audit partner, rather than the audit firm, to rotate best promotes the twin goals of an independent audit performed by qualified and experienced auditors. For this reason, we also agree with the GAO's conclusion that mandatory audit firm rotation may not be the most efficient way to strengthen auditor independence and improve audit quality considering the additional costs it would entail and the other reforms being implemented at the time.⁸

Moreover, boards are guided by their own responsibilities and duties—namely, their fiduciary duty to protect the interests of fund shareholders—to promote the integrity of fund audits. Virtually every fund's audit committee is composed entirely of independent directors. This has been adopted as a best practice even though funds are not required to do so unless relying on certain SEC rules.⁹ In addition, the vast majority of fund boards (97%) have a financial expert on the audit committee.¹⁰ This strong oversight mechanism provides ample protection and further renders an audit firm rotation requirement unnecessary.

Finally, there are a number of other incentives, such as the PCAOB's own inspection and enforcement programs, as well as the ever-present threat of litigation, that help to ensure the independence, objectivity, and professional skepticism of audit firms.¹¹

⁶ See [Strengthening the Commission's Requirements Regarding Auditor Independence](#), SEC Release No. 33-8183 (January 28, 2003).

⁷ *Id.*

⁸ See U.S. General Accounting Office, [Required Study on the Potential Effects of Mandatory Audit Firm Rotation](#) (November 2003) ("GAO Report").

⁹ See ICI [Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness](#) (June 24, 1999).

¹⁰ ICI/IDC [Overview of Fund Governance Practices](#), 1994-2010.

¹¹ For an additional discussion of the existing mechanisms that ensure professional skepticism, see Letter from Gregory M. Smith, Director – Fund Accounting, ICI to Mr. J. Gordon Seymour, Secretary, PCAOB, regarding Concept Release on Auditor Independence and Audit Firm Rotation; PCAOB Rulemaking Docket Matter No. 37 (Dec. 14, 2011).

Mandatory Rotation Would Likely Have Adverse Effects on Fund Audits

We have serious concerns that if an audit firm rotation requirement were adopted, the adverse effects on fund audits would be significant. Specifically, mandatory rotations could impose unnecessary burdens on fund boards and fund managers, diminish the quality of audits, enhance the risk that problems may be associated with the audit, and increase audit costs.

Funds can and do change audit firms under circumstances appropriate for the particular fund, but replacing one of a fund's principal service providers is a significant undertaking and one that funds do not typically undergo without serious consideration.¹² First, the process of selecting a new audit firm can be burdensome to both the fund's board and the fund's manager. This process includes interviewing auditors and evaluating a significant amount of information regarding the resources, capabilities, reputation, and, as discussed more fully below, independence, of each audit firm under consideration. Once selected, the new auditor would need to spend additional time working with the fund's manager to understand and document the fund's structure, trading strategy, operations, and internal controls to enable it to develop its initial audit plan. This process could be complicated by the extent to which fund operations are outsourced. A new audit firm's lack of familiarity with the fund also could increase the risk of problems with the audit.

The new audit firm's initial review, as well as the transition process, would be disruptive and time-consuming, and likely distract the fund manager and board from other important responsibilities. The disruption of changing audit firms would be particularly acute for fund complexes that stagger the fiscal year ends of their funds and, thus, are in a "continuous audit cycle."¹³ Moreover, the additional time and effort involved in "getting up to speed" could translate into an unnecessary increase in audit costs, which ultimately would be borne by fund shareholders. Indeed, in a study by the GAO, large audit firms estimated that, under mandatory audit firm rotation, initial year audit costs would increase by more than 20 percent over subsequent year costs because of the need to acquire the knowledge necessary to perform the audit.¹⁴

Another negative impact on audit quality and cost may occur by virtue of the fact that audit firms will know their client relationships will end at a set time. If an audit firm knows its relationship with a client will sunset at a predetermined time, the auditor may be more focused on looking over the

¹² See [IDC Task Force Paper on Board Oversight of Certain Service Providers](#) (June 2007).

¹³ The use of staggered fiscal years is a mechanism to help manage the workflow associated with the end of each fund's fiscal year, which includes the update to the fund's registration statement as well as the preparation and audit of its financial statements.

¹⁴ See GAO Report, *supra* note 8.

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horizon for its next client and less focused on the existing client's audit. Likewise, if an audit firm knows its engagement is for only a limited period, the auditor may have less incentive to negotiate its fees. Higher audit fees would likely have a disproportionate impact on smaller fund complexes, and in particular new complexes, that struggle to compete with more established and larger fund complexes.

Our Concerns are Heightened by the Limited Number of Qualified Audit Firms

Our concerns about a mandatory audit firm rotation are heightened in the fund context due to the limited number of audit firms that are qualified—in terms of expertise and independence—to audit funds. If funds are forced to rotate audit firms and engage a firm that does not have sufficient experience and expertise in auditing fund financial statements, the impact on audit quality, risk, and cost would be that much more severe, to the detriment of fund shareholders.

Auditing fund financial statements requires specialized industry and regulatory expertise. Only a limited number of audit firms currently possess this expertise. Firms that perform fund audits typically have personnel dedicated to the asset management industry who are knowledgeable about the industry-specific accounting model required by FASB Topic 946, the special tax status afforded funds under Subchapter M of the Internal Revenue Code, and the overlay of the 1940 Act. In addition, because fund audits require the audit firm to test the valuation of 100 percent of a fund's assets, the audit firm would likely need a dedicated team of valuation experts, who can value complex or thinly traded securities where market quotes are not readily available. A "deep bench" of audit partners with this expertise is oftentimes necessary for complexes with continuous audit cycles for funds with staggered fiscal years.

The universe of qualified fund auditors is made even smaller by factors specific to the fund industry. For instance, the broad definition of "investment company complex," generally speaking, is defined as 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 fund business. Thus, a fund whose adviser is part of a larger financial services organization, such as a bank or insurance company, may experience difficulty finding audit firms with the necessary expertise because those firms may otherwise provide consulting services to the parent company, thereby prohibiting them from serving as auditors to the fund. When faced with a choice, these firms are not likely to forego large consulting fees in exchange for the significantly smaller fees associated with fund audits.

Moreover, we understand that some audit firms adopt policies beyond the strict confines of Rule 2-01 of Regulation S-X to ensure their independence from fund clients. For example, while employees not associated with the engagement, in the engagement office, or in the chain of command may invest in funds within the engagement of an auditor, some audit firms may still prohibit *all* employees and their family members from investing in the funds. This issue is especially problematic for the funds offered through an audit firm's 401(k) retirement plan to its employees. Efforts to cure these independence issues may take the form of a firm-wide divestment requirement, which would be

disruptive to the operation of the retirement plan and to the individuals who are impacted, or a policy to refrain from auditing certain large fund complexes, which further limits the universe of audit firms available to fund complexes.

The limited number of qualified audit firms in the fund industry is evidenced by informal ICI data, which reveal that only four accounting firms serve as auditors to 94% of funds and that these funds represent about 99% of industry assets. In addition, the remainder of the funds in the industry, which are among the smallest funds in the smallest complexes, are audited by only a handful of other accounting firms. Some believe that mandatory audit firm rotation could present an opportunity for accounting firms other than the few large audit firms to compete.¹⁵ But these firms currently do not have the expertise and experience typically necessary to audit fund financial statements. Assuming that they would be able to develop this expertise is speculative and fails to take into account the significant time and resources necessary to do so.

The Authority and Discretion of Fund Boards and Audit Committees Would Be Undermined by Mandatory Audit Firm Rotation

The Release does not acknowledge the important role of fund boards and their audit committees in overseeing fund audits and makes no mention of the unique statutory and regulatory framework for funds established by Congress in the 1940 Act and by SEC rules. We firmly believe that the PCAOB should not infringe upon this long-standing and successful framework by imposing a mandatory audit firm rotation requirement.

A primary duty of a fund board audit committee is to recommend to the board's independent directors the selection of the fund's auditor. A mandatory rotation of audit firms would undermine the authority and discretion of the committee, which works diligently to oversee the auditor and make determinations that are in the best interest of the fund and its shareholders. Determining whether to retain the fund's current auditor and, if not, the most appropriate time to replace the auditor is a decision best left to the judgment of a fund's independent directors, taking into account the particular facts and circumstances of the fund.

The Release also raises the possibility of prohibiting audit committees from removing an auditor "without good cause" prior to the end of a fixed term. The Release is silent as to how a "good cause" standard would be defined and who would make that determination. We are concerned that this standard would further marginalize the discretion of independent directors in determining the most appropriate auditor for the funds they oversee.

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¹⁵ See Release, *supra* note 2.

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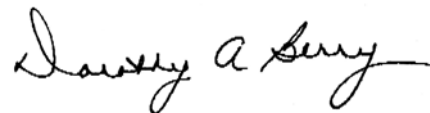
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For the reasons discussed above, IDC strongly opposes mandating audit firm rotation for funds. We fail to see a basis for the mandate for funds inasmuch as the PCAOB has not cited any concerns with respect to fund audits, nor are we aware of any, and there is no clear correlation between any audit deficiencies and a lack of auditor independence. We firmly believe that mandatory audit firm rotations could impose unnecessary burdens on fund boards and fund managers, diminish the quality of audits, enhance the risk that problems may be associated with the audit, and increase audit costs, all to the detriment of fund shareholders. Also, an audit firm rotation mandate would be impracticable for funds given the limited number of qualified audit firms. Finally, a mandatory audit firm rotation requirement would inappropriately marginalize the role of fund boards and their audit committees.

IDC commends the PCAOB's focus on ensuring high quality audits and, as part of this effort, we encourage the PCAOB to study ways to improve its communications with and education of audit committee members. If we can be of assistance in this regard, or if you have questions concerning our comments, please do not hesitate to contact Amy Lancellotta, IDC Managing Director, at 202/326-5824.

Sincerely,



Dorothy A. Berry
Chair, IDC Governing Council

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

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