

## ICI VIEWPOINTS

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## PCAOB Must Demonstrate Need for Mandatory Audit Firm Rotation

By Amy Lancellotta and Gregory Smith

The [Independent Directors Council](#) (IDC) and the [Investment Company Institute](#) (ICI) oppose requiring a mandatory rotation of audit firms as detailed in a [concept release](#) from the Public Company Accounting Oversight Board (PCAOB). As our comment letters point out, the PCAOB has not clearly connected audit deficiencies discovered through its inspections of audits to a lack of auditor independence. Further, the PCAOB has failed to demonstrate any audit deficiencies specific to audits of investment companies.

With its concept release, the PCAOB is seeking ways to improve auditor independence, objectivity, and professional skepticism. According to the Board, limiting the number of consecutive years for which a registered public accounting firm could serve as the auditor of a public company—including a fund—may help avoid relationships between auditors and management that protect long-term relationships to the detriment of investors. The Board also believes mandatory audit firm rotation can create incentives for auditors to perform more-rigorous audits because they know that the successor auditor will scrutinize their work. Such an arrangement also enables the successor auditor to take a “fresh look” at the company’s financial reporting.

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. Existing safeguards and recent enhancements to auditing standards are more than adequate to assure the independence of auditors. Indeed, we believe public company audits have improved significantly since the [Sarbanes-Oxley Act of 2002](#) and its audit-related reforms.

A mandatory audit firm rotation could increase costs. The successor auditor would necessarily have to build additional hours during the first years of its tenure in order to become familiar with the client’s business, systems, and control environment. These additional hours could result in increased audit fees, which would be borne by fund shareholders. If the PCAOB’s proposal were implemented, [a study estimated](#) that initial year audit costs would increase by more than 20 percent over subsequent year costs.

Ironically, audit firm rotation could even increase the risk that the auditor will fail to detect errors or misstatements. The loss of institutional knowledge the incumbent auditor brings to the engagement, combined with a steep learning curve that the successor auditor must climb, may increase audit risk.

Our concerns about mandatory audit firm rotation are heightened in the fund context because of the limited number of audit firms that are qualified—in terms of expertise and independence—to audit fund financial statements. Auditing fund financial statements requires specialized industry and regulatory expertise. Only a limited number of audit firms currently possess this expertise. In addition, the universe of independent auditors able to satisfy the auditor independence requirements is made even smaller by factors specific to the fund industry, such as the broad definition of “investment company complex” and the use of funds offered through an audit firm’s 401(k) retirement plan to its employees.

Mandatory audit firm rotation would also undermine the authority and discretion of fund boards and their audit committees. As IDC explained, the Investment Company Act of 1940 (1940 Act) has long required independent directors to select a fund’s auditor. Indeed, picking an audit firm is one of only four responsibilities that the 1940 Act specifically assigns to independent directors—a clear measure of the importance of the audit function and the role of fund independent directors. This statutory approach has worked well, and the PCAOB should not infringe on its success. Determining whether to retain the fund’s current auditor is best left to the judgment of a fund’s independent directors, who work diligently to oversee fund audits and make determinations that are in the best interest of the fund and its shareholders.

We support the PCAOB's mission to oversee the audits of public companies—including funds—to protect the interests of investors. In this concept release, however, the PCAOB fails to demonstrate how mandatory audit firm rotation would support that mission.

Additional resources:

- [Frequently Asked Questions About Mutual Fund Directors](#)
- Read more about ICI's work in [Operations and Technology](#).
- [Independent Directors Council](#)

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