



Written Testimony

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Creators”

## **Introduction**

My name is Robert Smith and I am currently the Corporate Secretary, Vice President & Deputy General Counsel of NiSource, Inc., a mid-cap energy holding company, providing natural gas, electricity, and other products and services. It operates in three segments: Gas Distribution Operations, Gas Transmission and Storage Operations, and Electric Operations.

I also Chair the Policy Advisory Committee of the Society of Corporate Secretaries and Governance Professionals (the "Society"). The Society is a professional association, founded in 1946, with over 3,000 members who serve more than 1,500 public, private and non-profit organizations. At our companies we seek to develop corporate governance policies and practices that support our boards to foster the interests of long term stockholders. Our members generally are responsible for their companies' compliance with the securities laws and regulations, corporate law, and stock exchange listing requirements. More than half of our members are from small and mid-cap companies.

I am honored to give testimony before this Subcommittee on behalf of the Society.

## **Background**

The Subcommittee has asked for our views on any of the following four legislative proposals on which we have expertise, H.R. 1135, the Burdensome Data Collection Relief Act, H.R. 1105, Small Business Capital Access and Job Preservation Act, H.R. 1564, Audit Integrity and Job Protection Act, and a bill to amend Section 913 of the Dodd-Frank Act. The Society's testimony will be limited to H.R. 1135 and H.R. 1564. H.R. 1135 seeks to repeal Section 953(b) of the Dodd-Frank Act which requires companies to disclose the median of annual total compensation (as calculated under Item 402 Reg S-K) paid to all employees of the company (other than the CEO) as well as the annual total compensation paid to the CEO, and then provide a ratio comparing those two numbers ("Pay Ratio"). This testimony will also address H.R. 1564, which seeks to prevent the PCAOB from requiring that companies' audits be performed by specific auditors or that they be performed by specific auditors on a rotating basis ("Auditor Rotation").

## **Summary Comments on Pay Ratio**

We acknowledge a public policy concern on pay gaps in the United States; however, we strongly believe the required ratio will not be material or meaningful to investors in company securities. Accordingly, we believe the provision should not be implemented at this time; rather this section should be repealed. We also believe that it will be virtually impossible for large global companies to comply with Section 953(b) as now written, and that implementation will impose a substantial burden even on smaller non-global issuers.

We note also that the SEC faces challenges in implementing the many Dodd-Frank Reforms as well as the JOBS Act. The SEC must prioritize and focus on the most important issues facing investors and the securities markets. SEC Commissioner Dan Gallagher raised this issue last week in his “Remarks at 12th European Corporate Governance & Company Law Conference” in Dublin:

The question that policymakers need to answer at the end of the day is: do all of these mandates aid the average investor? At best, it is questionable. For example, an unintended consequence of the disclosure requirements imposed at the federal level in the U.S. over the past 15 years is that proxy statements now resemble law school text books. Who can blame an investor for not voting when reading a proxy and voting a proxy card evoke memories of studying for a final exam?

And as noted by former SEC Commissioner Harvey Pitt in a speech earlier this month to the U.S. Chamber of Commerce titled “Shareholder Activism: A Cost-Benefit Analysis”:

[T]he SEC should stick to its knitting, delay (or cease) implementing those elements of Dodd-Frank that force it to abandon its mandate to promote shareholder value, and petition Congress to undo the mischief it’s foisted on all of us by virtue of Dodd-Frank. In these interesting and perilous times, with perseverance, creativity and a sense of humor, we can overcome these Congressionally-mandated assaults on American Capitalism.

### **The Pay Ratio Would Not Provide Meaningful Information to Investors**

The Society does not believe the Pay Ratio provides useful data for investors, who under existing SEC requirements have access to extensive disclosure on senior executive compensation. It is important to keep in mind that SEC disclosure documents are meant to contain information that a “reasonable investor” needs to make an investment decision. The “reasonable investor” standard for materiality is well-established under law. SEC disclosure documents are not meant to contain every item of information that any investor could possibly want to know. Proliferation of disclosure requirements not centered on a disciplined standard will make SEC disclosure documents unusable for the average investor, as Commissioner Gallagher laments, while adding costs that ultimately are borne by investors.

The Pay Ratio under Section 953(b) will not provide useful information to investors because it is not comparable in any way – across industries, companies, geographies, or employees. For example, companies located in certain areas of the country pay employees and executives more than others, given the cost of living in those areas. Some businesses have a large number of low-paid workers and some have a higher percentage of part-time employees or seasonal employees. These companies will likely

have “worse” Pay Ratios. Some companies have outsourced jobs to locations with lower pay levels in an effort to save costs, and these companies may have “better” Pay Ratios than those that have chosen to maintain their operations (call centers for example) in the United States.

In addition, companies with franchisees rather than company-staffed stores will also likely have a “better” Pay Ratio. The Pay Ratio will not be a meaningful measure to compare to the CEO’s compensation, or to compare the pay practices within a single industry. For this reason we do not believe that shareholders will find this disclosure relevant in deciding whether to invest in the company, or on how to vote in election of directors, or how to vote on a “say on pay” resolution.<sup>1</sup>

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<sup>1</sup> **Illustration of lack of comparability:** A major factor in lack of usefulness of the Pay Ratio is the widely varying practices even within industries on outsourcing of production. Employees of vendors would not be included in the pay ratio. A company that keeps relatively greater production in-house would tend to have a significantly lower median “annual total compensation” than one that outsources extensively.

Consider the following hypothetical, using median “company” salary as currently calculated by Payscale.com in the United States (about \$60,000), Poland (about \$20,500) and India (about \$10,500); other forms of compensation for non-CEO employees are excluded for purposes of this example.

Company A has 1,000 employees, including 100 U.S.-based executives and other employees, all but the CEO paid at the market median. The other 900 employees are all in Poland and assemble the company’s products; assume all Poland employees are paid the same amount, at the market median.

Company B also has 100 U.S. based executive and other employees, with all but the CEO also paid at the market median. However, Company B outsources assembly of its products to another firm, which assembles the products in India. Company B has no other employees.

Assume each company’s CEO is paid \$1 million. The Pay Ratio for Company A will be “49:1” (\$1 million/\$20,500 of the median employee at the company), while that for Company B will be “17:1” (\$1 million/\$60,000). Company A appears to have relatively poor pay equity, even though its assembly work is done in Poland, which has substantially higher median pay than India, and even though the two companies otherwise are similar.

While this hypothetical is but one simplified example of the problem, it shows the danger in disclosing a ratio that is not based on similarly situated employees.

We submit that the key data points for considering pay equity that investors could use would be (1) CEO pay, which already is subject to extensive disclosure rules, and (2) market-wide pay information, which is publicly available from various government and private sources. So even aside from the question on whether investors generally would find pay equity ratios useful, the particular ratio mandated under 953(b) would be of limited or no use.

More generally, we believe the vast majority of investors are not interested in obtaining such pay ratio information from companies. We are aware of votes in 2010 on 9 shareholder proposals requesting reports on pay disparity. On average, the proposals were supported by only 6.1% of the shares voted. In 2012, one proposal received 7.2% support and in 2013, we are aware of only two such proposals. One has been voted on-- it received only 6.7% of the vote. The level of interest by investors is therefore extremely low.

Finally, since the enactment of Dodd-Frank, companies have been required to solicit investor votes on their executive compensation in what is commonly called the “say-on-pay” vote. This mechanism has been used in the last few years and has generated increasing levels of engagement by companies with their shareholders and others and continues to evolve. If investors are concerned that they need additional disclosure on pay equity from a particular company, they can (and do) use say-on-pay votes under Dodd-Frank to express their views. And, they still may submit shareholder proposals requesting such information, as noted above. With the evolution of the say-on-pay vote, however, we see fewer such proposals, leading us to conclude that Pay Ratio disclosure is a solution in search of a problem that does not exist.

### **The Pay Ratio Disclosure Requirement is Burdensome Well Beyond Any Potential Benefit**

Not only is the Pay Ratio disclosure requirement unnecessary and not meaningful, it also would be highly burdensome. While it appears to some observers to be a trivial addition to existing disclosure requirements, that is not the case. It is in fact highly prescriptive, which has hampered the SEC in its efforts to draft an implementing rule. Commissioner Gallagher made note of this in his Key Note address at the “Symposium on Building the Financial System of the 21st Century: An Agenda for Europe and the United States” in March in Switzerland:

Indeed, Dodd-Frank marked a tremendous expansion of prescriptive financial regulation, with much of the law’s rulemaking burden, including about 100 of its 400 rulemaking mandates, falling on the SEC. The very volume of Dodd-Frank’s prescriptive mandates to the SEC has had the unintended effect of significantly limiting the agency’s ability to bring its traditional expertise and judgment fully to bear in the rulemaking process. In that sense, it has had a negative impact on the Commission’s ability to develop sound, sensible regulation and to adapt quickly

and flexibly to the continuing transformation of global capital markets.

Commissioner Paredes also recognized this difficulty, as well as the particular burden in with Pay Ratio disclosure, in his Remarks at the Society's 66th National Conference on "The Shape of Things to Come" in July 2012:

First, regulation needs to be workable in practice for those who have to comply with it. This seems to be a particular concern when it comes to the CEO pay ratio disclosure. Having to compile extensive data for their employees in the U.S., let alone around the globe, and then ensure that the data is standardized so that the ratio can be calculated would seem to present significant practical difficulties that could be quite costly for companies. Developing the data to calculate the Pay Ratio would require much time by companies and would add a cost to the already high compliance burdens they face.

Then-SEC Corporation Finance Director Meredith Cross also testified in 2010 that she had concerns on whether the SEC staff can make the Pay Ratio provision workable. Other SEC officials have noted that the calculations required by the provision would be extremely difficult, especially for large, multinational corporations that pay workers throughout the world in a variety of methods. The difficulty mentioned then has not changed. And anecdotal evidence from one member of the Society with about 100,000 employees operating in 100+ countries estimated that costs to comply could run into the tens of millions of dollars. Another estimated \$5 million in costs plus 5-10 hours per employee, so more than 500,000 man hours for a company with 100,000 employees.

Given the definition of "annual total compensation" as set forth in Section 953(b)(2), many companies, including most large worldwide U.S. companies, would not be able to calculate the "median of the annual total compensation of all employees of the issuer" with the degree of precision and certainty required for information filed under the U.S. securities laws. Payroll systems are not set up to gather the kind of information required under this provision. This is especially the case for companies organized into multiple operating business units. Those business units keep records and have internal controls over what each employee is paid, but they generally report aggregated figures to the parent company for inclusion in consolidated financial reports for public filings. Thus, the parent company that files SEC reports often does not have direct access to the employee-by-employee data necessary to identify the median employee. This is complicated even further when operating business units are based outside the United States or employ people in multiple countries.

Moreover, Section 953(b) requires the issuer to disclose the median of all employees, using the same calculations as are used to determine total pay for named executive officers under the proxy rules. In other words, a company would have to convert the pay of each employee globally into the pay formula applicable to the named executive officers in the Summary Compensation Table. To our knowledge, no public company

now calculates each employee's total compensation in the way it is required to calculate total pay on the Summary Compensation Table for named executive officers (usually five individuals). Disclosure of executive pay has a different purpose than internal accounting.

For a company with tens or hundreds of thousands of employees, this would be a large and costly task. Note that many global corporations house compensation data in dozens of computer systems. It is not clear that companies could perform consistent calculation for each employee in all countries and ensure that the results are accurate, even with large expenditure on the data.

As we indicated in Society testimony in 2010, there are a number of questions that must be answered by corporate staff trying to compile data necessary to identify the median employee, including the following:

- How do you handle currency conversions for non-U.S. employees? What rate do you use and as of what date?
- In many parts of the world, compensation includes non-monetary components, such as transportation, housing, direct medical care, security, and sometimes even food. How do you treat these kinds of compensation?
- What if you have employees in countries where local privacy laws do not allow personal compensation information to be sent across borders without express employee consent?
- How do you treat company-matched contributions to 401(k) plans? And, what about company matched contributions to a 401(k) plan that is invested in company stock or discounted employee stock purchase plans? Should we treat those as equity compensation?
- How do you treat employees brought in as part of a mid-year acquisition or new employees that started mid-year? Conversely, how do you treat employees that left as part of a mid-year disposition or were terminated mid-year?
- How do you treat severance paid to terminated employees?
- How do you treat special early retirement programs?
- How do you treat overtime and shift differential payments for hourly workers and non-exempt employees? Is that included in "All Other Compensation"?
- For those employees who have an eligibility waiting period how do you treat the

waiting period?

- What about store discounts? Are they excludable?

### **Summary Comments on H.R. 1564, Mandatory Audit Firm Rotation**

The Society also supports H.R. 1564, the Audit Integrity and Job Protection Act. Mandatory auditor rotation interferes with the relationship between the audit committee and its audit firm and we believe it would not be beneficial to audit quality and would not enhance auditor independence, objectivity or skepticism. Moreover, it would be costly and burdensome to companies without a corresponding benefit. On December 11, 2011, The Society commented on PCAOB Rulemaking Docket Matter No. 37 Concept Release on Auditor Independence and Audit Firm Rotation (the "Release"). A copy of that letter is attached as Exhibit B, and set forth below in substantial part but with citations omitted.

### **Mandatory Auditor Rotation Has Been Considered On Several Occasions and Never Adopted**

The notion of requiring public companies to periodically rotate their independent audit firms is not new. In fact, the Release itself notes various instances in which this concept has been considered by both Congress and the SEC over the last 40 years. Each time, mandatory rotation has been rejected, principally due to the increased costs and risks caused by rotation coupled with the lack of any significant benefit to investors. According to the Release, in 1994, an SEC study concluded that "the [profession's] requirement for a periodic change in the engagement partner in charge of the audit, especially when coupled with the requirement for second partner reviews, provides a sufficient opportunity for bringing a fresh viewpoint to the audit without creating the significant costs and risks associated with changing accounting firms."

Congress considered mandatory rotation when it made sweeping reforms in the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"). However, at that time, instead of requiring rotation, Sarbanes-Oxley commissioned a study and review of the potential effects of requiring mandatory rotation. The United States General Accounting Office's ("GAO") report concluded:

We believe that mandatory audit firm rotation may not be the most efficient way to enhance auditor independence and audit quality, considering the costs of changing the auditor of record and the loss of auditor knowledge that is not carried forward to the new auditor. We also believe that the potential benefits of mandatory audit firm rotation are harder to predict and quantify while we are fairly certain there will be additional costs. In that respect, mandatory audit firm rotation is not a panacea that totally removes pressures on the auditor in appropriately resolving financial reporting issues that may



materially affect the public companies' financial statements. Those pressures are likely to continue even if the term of the auditor is limited under any mandatory rotation process.

Instead of mandating rotation, Sarbanes-Oxley Section 301 required the rotation of the lead audit partner every five years and other audit firm employees with significant involvement in the audit every even years. The Society believes that these existing requirements, *particularly partner rotation*, adequately address the concerns of professional skepticism and ongoing objectivity.

### **As Contemplated by Sarbanes-Oxley, Audit Committees Should Have Sole Responsibility for Auditor Selection**

Perhaps the most significant auditor independence and audit quality enhancement adopted pursuant to Sarbanes-Oxley was Rule 10A-3 under the Securities Exchange Act, which made the appointment, compensation and oversight of independent auditors the sole responsibility of a company's audit committee. In adopting this Rule in 2003, the SEC noted that "[o]ne of the audit committee's primary functions is to enhance the independence of the audit function, thereby furthering the objectivity of financial reporting... One way to help promote auditor independence, then, is for the auditor to be hired, evaluated and, if necessary, terminated by the audit committee. This would help to align the auditor's interests with those of shareholders."

We believe that these considerations remain valid and that, as a result, the audit committee should continue to have sole responsibility for selecting a company's audit firm, and the audit committee is best able to judge if the audit firm is bringing the right level of technical competence, objectivity and professional skepticism to its work. Under mandatory rotation, however, the committee would be required to select another firm, even if it believed that another firm may not discharge its responsibilities as effectively and independently as the current firm.

Sarbanes-Oxley's numerous audit committee requirements were furthered by subsequent rules of self-regulatory organizations that strengthened the committee's responsibilities for oversight of the audit firm, including requirements entailing heightened levels of independence and expertise of audit committee members. These and other safeguards strengthen the audit committee's oversight of audit firms, and requiring audit firm rotation would undermine the critical role played a company's audit committee in ensuring the independence and objectivity of a company's audit firm as well as interfering with this body of rulemaking developed by the SEC and self-regulatory organizations.

Public company directors have fiduciary duties that require a high degree of diligence in gathering and considering the information necessary to make informed decisions, including those in selecting a company's independent auditor. In discharging these

responsibilities, there may be many valid reasons for an audit committee to determine that rotation to a new audit firm is not in the best interests of its company at a particular point in time. Therefore, mandatory rotation would unnecessarily impinge on the audit committee's independent decision-making and implement a one-size-fits-all approach over the informed business judgment of a company's audit committee based on relevant facts and circumstances.

### **The Costs of Mandatory Rotation Clearly Outweigh Any Benefits**

The Society believes that a change as significant as mandatory audit firm rotation must be based on clear objective data showing that mandatory audit firm rotation will achieve a benefit. First, there must be evidence of a link between audit firm failure and long-term tenure and second, there must be evidence that rotation will consistently result in measurably improved audit quality that justifies the increase in direct, indirect, and ancillary costs. Past studies have never yielded definitive proof that rotation would achieve the PCAOB's stated aims of enhancing auditor independence in mental attitude, objectivity or professional skepticism or otherwise improving audit quality. In contrast, as detailed below, there is evidence of increased risk of audit failure and reduced audit quality from auditor rotation.

The costs underlying a rotation requirement for both audit firms and public companies exist at the various stages of the process: the search for and selection of the new audit firm, the costs of changing firms and finally the costs of rotating the audit firms after a certain amount of time.

### **Society Members Surveyed Estimate 20% Increase in Costs**

Based on a survey of our members and discussion with member companies that have changed their audit firms, the direct, indirect and ancillary costs associated with mandatory auditor rotation would be considerable. Our survey revealed that over 70% of those companies that could estimate additional costs resulting from mandatory rotation believe that costs in the initial year would increase by at least 20%.

*Selection of New Audit Firm.* Each time an audit firm rotation occurs, the company's audit committee, management and employees in its finance, legal, tax, accounting, and internal audit organizations, across all the jurisdictions in which the company operates, must invest significant amounts of time and money to ensure selection of an appropriate new audit firm. The complex process in evaluating a potential new audit firm includes consideration of numerous factors, including the firm's reputation; the firm's knowledge and experience in the company's current and prospective industries and lines of business; the proposed new lead partner's overall business acumen, knowledge and experience in these industries and businesses; the depth of expertise, experience and knowledge of the prospective engagement team; potential conflicts of interest or independence issues with the Board; the scope of the audit firm's

international network in the countries and regions in which the company operates, and the firm's ability to provide quality services across those countries and regions; the firm's quality control procedures; findings from recent firm inspections, peer reviews or other oversight reviews; and whether the firm will be able to meet the auditor independence requirements. The consideration of each of these factors would likely necessitate thousands of hours of work and analysis and concomitant expenditures.

To illustrate, one of our members, a large global company that voluntarily rotated its audit firm within the past ten years, estimated that the time expended from the start of the request for proposal process through retaining its new audit firm entailed approximately 100 hours of audit committee time, 500-600 hours of senior management time and between 2,000-3,000 hours of finance, legal, tax, accounting, and internal audit employees' time, in addition to the associated administrative and productivity costs. It would be inefficient to require thousands of company hours every five or ten years to assess an audit firm change, especially when such a change may not be needed or be in the best interests of a company or its shareholders.

*Transition to New Audit Firm.* Once an audit firm has been retained, a significant amount of company management time and attention is required to provide the successor firm with the information needed to plan its audits and to support the new firm while it gains familiarity with the company; its history, businesses, operations and facilities; its accounting systems and records; its accounting policies and methodologies; its internal control systems and processes; its information technology systems and applications; and other necessary systems, processes and personnel. In addition, a change in audit firm requires management to respond to an increased volume of audit firm staff requests, including requests for documentation that supports accounting positions that may have been in place for a number of years. A company's audit committee must maintain an appropriate level of oversight throughout the entire process.

The global member company referenced above estimated that the support required to orient the new firm and ensure a successful transition during the first year of its engagement encompassed approximately 20% of the work time hours of over 100 people throughout the organization.

The Society believes that mandatory auditor rotation will lead to both increased audit costs as well as increased costs for audit-related services. This is supported by the GAO's 2003 Report, which found that nearly all of the larger audit firms surveyed estimated that initial year audit costs would be more than 20% higher than subsequent years' costs; the responses from the Fortune 1000 public companies were similar. As discussed above, our members' estimates of increased first year costs are comparable.

The GAO survey also addressed the overall costs to both audit firms and Fortune 1000 public companies, including estimated indirect and ancillary costs, consisting of

marketing costs (i.e., the costs incurred by the audit firm related to their efforts to acquire or retain financial statement audit clients), selection costs (i.e., the internal costs incurred by a public company in selecting a new public accounting firm as the public company's auditor of record), and support costs (i.e., the internal costs incurred by a public company in supporting the public accounting firm's efforts to understand the public company's operations, systems, and financial reporting practices). The GAO estimated additional first year audit-related costs (inclusive of the foregoing costs as well as audit costs) would be 43% to 128% (and, on a weighted average basis, 102%) higher than the likely recurring audit costs had there been no change in the audit firm.

The Society members' experience is that audits in the initial years after a change in audit firm are less efficient and more expensive. Audit fees are generally based on the expected hours needed to complete the scope of work set out in the audit plan. Initial years' audits and audit related services take more time and are inherently less efficient, and thereby more expensive, than subsequent years' services. Among other matters, the new audit firm must review the predecessor auditors' documentation, obtain a complete understanding of historically significant events, and gain an understanding of the company's business model, control environment and reporting practices, in order to appropriately determine the scope and conduct of its audit. It takes time before an auditor can appropriately coordinate with a company's internal audit staff and ascertain the appropriate staffing and conduct of its audit, which impacts both the direct costs of the audit and the quality of the audit. Appropriate reliance on internal audit staff and knowledge gained from its prior work enable an outside auditor to focus its audit personnel on the higher risk areas of an audit.

### **Rotation Would Negatively Affect Audit Quality and Would Have Minimal Benefits, if Any**

While the Release suggests several potential benefits associated with rotation, the Society believes that mandatory auditor rotation will introduce significant issues that would likely contribute to an actual *decrease* in audit quality.

Evidence in the Release indicates that audit quality in the first years of an engagement tends to be lower, and therefore could lead to a greater risk of audit failure. With a mandatory rotation rule in place, companies will spend more time in a short-tenure audit situation, and overall audit quality will be negatively impacted. More than 85% of our members surveyed were "very concerned" about the loss of its audit firm's institutional knowledge if required to switch auditors.

Finally, incoming auditors, unfamiliar with the details of a new client's business, will be less likely to identify fraud or deception on the part of a company's management and employees. The accumulated experience of a longer audit tenure helps a firm better spot and account for these issues. Studies conducted in 1987, 1999 and 2010 revealed numerous audit failures involving companies that recently changed auditors – and the

2010 study concluded that the topic needed to be studied more.

It seems likely that audit firm rotation will lead to a merry-go-round in provision of audit-related services, as there are limits on non-audit work that can go to the audit firm. This has various ramifications, among them that the outgoing audit firm is likely to be among those acquire newly-available non-audit engagements previously fulfilled by the incoming audit firm. The same concerns presented by advocates of mandatory rotation – reduced professional independence – will manifest here, as there is a risk that an incumbent audit firm may seek to placate management in order to obtain non-audit business upon rotation.

Given the inability to date to demonstrate the link between mandatory auditor rotation and enhanced auditor independence, objectivity and professional skepticism (and thus, presumably, increased audit quality), costs of the magnitude discussed above clearly are not justifiable, particularly in the context of information and projections indicating that such a requirement may in fact result in reduced audit quality in the earlier years of an engagement. (See M. Cameran, A. Prencipe, and M. Trombetta, *Auditor Tenure and Auditor Change: Does Mandatory Rotation Really Improve Audit Quality?*, Proceedings of the Annual Meeting and Conference on Teaching and Learning in Accounting, New York 1-61, at p. 19-20 (2008).)

The Concept Release outlines two commonly-argued “fresh look”-related benefits, but does not present any empirical evidence that these benefits actually exist. Because clients utilize different accounting methods depending on industry sector and company preferences, an incoming auditor will need to become familiar with the client company’s individual practices and control structure. Even among similar or identical accounting procedures, an auditor must gain familiarity with the particular business and internal operations of the client, and must rehash the solutions developed by the predecessor.

Suggested remedies for this some of the problems presented by mandatory rotation would exacerbate other detriments of the regime. For example, mandatory auditor rotation is already anti-competitive because it decreases the opportunity costs of cartel-like behavior and reduces the incentives for audit innovation. Reduced quality in initial years of audit engagements could be mitigated by mandatory standardization of audit practices and techniques between audit firms and clients. However, this would exacerbate the anti-competitive effects of mandatory auditor rotation by either preventing innovation entirely, or speeding up the transfer of innovation from the innovator to the rest of the industry, resulting in a disincentive to make such improvements and thereby harming audit quality.

When mandatory auditor rotation forces an audit firm to lose an engagement for which it has developed a specialized audit unit, it will not have the convenience of simply shifting those specialized resources to another, similarly-specialized project. While this effect may be ameliorated in a larger market, it will be magnified in smaller markets in

less densely-populated areas.

### **The PCAOB's Inspection and Enforcement Powers are Sufficient to Ensure Professional Skepticism**

The Society supports H.R. 1564 because mandatory audit rotation is not necessary to ensure professional skepticism. In fact, the PCAOB's existing powers are adequate. This includes the authority to (i) regulate audit firms, (ii) publicize a firm's audit failures and (iii) assess penalties (both financial and professional) on auditors they judge to be lacking in professional skepticism. These tools provide an effective arsenal to address issues with the firms through monetary penalties, professional penalties and by publicity of failures that would adversely impact their customer base and, ultimately, an audit firm's ability to retain clients. In this regard, we believe that the PCAOB is in a unique position to speak out on the need for auditor skepticism and thereby heighten sensitivity to the topic.

On the other hand, mandatory rotation of external auditors would be an ineffective means of addressing the risk of inadequate professional skepticism, primarily because it fails to consider that *an auditor can be more skeptical when he or she has a full understanding of the facts and circumstances related to their clients' businesses*. Mandatory rotation of external auditors will not cure this purported problem.

### **Mandatory Audit Firm Rotation Would Leave Public Companies with Few Experienced and Eligible Audit Firms**

Many public companies—large multinational companies in particular—have very limited choices for audit firms. In fact, many of these public companies can, as a practical matter, only use one of the four large audit firms known as the “big four” to provide audit services.

The “big four” audit firms are unique in their scale and scope. As the Concept Release acknowledges, even among the “big four” audit firms, a company's choice may be further limited because different audit firms have various capacities in different parts of the U.S. and world with differing areas of expertise. And Society members consider these factors critical in considering the selection and retention of an audit firm. In fact, nearly 90% of our members surveyed concluded that its company's audit committee evaluates audit firms based on industry knowledge or international scope and considered these items “very important” in the selection of the audit firm.

For instance, a company may need an audit firm with expertise in a particular industry or geographic area, and even the largest audit firms do not necessarily have the requisite specialized knowledge in every location in the world or even in the U.S. It is also not clear whether the “big four” audit firms or the smaller audit firms would be able or willing to devote the necessary resources to build expertise in new geographic

locations or in new industries.

Further complicating this issue are other auditor independence standards that would often preclude at least one firm from being selected as the independent audit firm. For example, if an immediate family member of a company's director is employed by one of the big accounting firms, the NYSE's independence rules may preclude that company from engaging the audit firm during the entire director's tenure on a company's board.

Additionally, independent auditors are prohibited from performing certain non-audit services, such as valuation work for their audit clients, and therefore most large public companies engage one or more of the remaining three of the "big four" audit firms to perform these non-audit services. Our survey revealed that over 83% of companies used at least one additional "big four" firm for non-audit services and a majority of companies utilized at least two additional "big four" firms. Over 85% of our members indicated that mandatory audit firm rotation would limit the company's ability to use other audit firms to provide non-audit services. If such companies wished to retain a firm within the "big four" and avoid the risk of auditor independence problems, they would be required to refrain from using at least one of the remaining three audit firms for non-audit services.

In addition, if they are currently using each of the remaining three audit firms to provide non-audit services, to identify and attempt to unwind all of the contracts for the non-audit services with at least one of such firms before the change in auditors. To state this is to show how difficult, risky and cumbersome it would be. This is a major issue for a significant number of our members and a mandatory audit rotation rule would disrupt many of the engagements and relationships that companies currently have with audit firms.

Also, many large public companies also engage one or more of the remaining three of the "big four" audit firms for tax compliance and consulting work, even though these are not prohibited services under Sarbanes-Oxley, the Exchange Act or applicable accounting standards. These companies believe that there are strong governance reasons for engaging a firm that is not their auditor to perform these services.

As a consequence of all of these limitations, if required to rotate, an audit committee will be significantly restricted in its selection of a new audit firm.

### **Mandatory Auditor Rotation would Impose a Disparate Burden on Small- and Mid-Cap Public Companies**

Finally, the Society believes that mandatory audit firm rotation would pose a disparate burden on small- and mid-cap public companies. Generally, these additional burdens would manifest themselves by either straining already resource-limited accounting and legal staffs of these companies and/or by decreasing the attention an auditor would pay

toward these companies. For smaller companies, having to assist in the “ramp up” learning period every five or ten years (or other mandated period) may well cause an a bigger hardship than for larger companies. For many small- and mid-cap public companies, the audit engagement team interacts primarily with the Chief Financial Officer, Controller, Director of Financial Reporting (if there is one), and the General Counsel (again, if there is one). While learning a smaller company’s business, industry, and accounting systems and processes may be less complex than at a larger issuer, small- and mid-cap public companies have significantly less resources to devote to educating a new audit team every few years. As a result, either the auditor will not be as “up to speed” as it could be or the financial and legal staff of the issuer will not have as much time in fulfilling their own responsibilities with regard to the audit. In either case, a higher risk of audit failure is the result.

While strained resources are a very significant risk, the greater risk may be the likelihood that auditors will decrease their focus on small- and mid-cap public companies. The Society is concerned that the smaller fees necessarily charged for smaller company audits coupled with a limited client retention period might cause the “big four” firms to avoid bidding on audit engagements for small- and mid-cap companies, limiting the pool of auditors available to these companies.

We believe that mandatory auditor rotation will lead to decreased attention and focus of audit firms, higher audit fees than exist today, but not high enough to support a large pool of auditor choices for small- and mid-cap public companies.

## **Summary**

In summary, we believe that the Dodd Frank Pay Ratio provision is simply unworkable and would produce information that is not meaningful to investors. Similarly, we believe that imposing mandatory audit firm rotation on companies is also unworkable and would not enhance auditor independence, objectivity or skepticism but could in fact jeopardize audit quality.

I want to thank the Subcommittee again for the opportunity to provide testimony, and indicate the willingness of the Society to answer questions on either of these resolutions now or in the future.