IESBA INTERNATIONAL ETHICS STANDARDS BOARD FOR ACCOUNTANTS
545 Fifth Avenue, 14th Floor, New York, New York 10017 USA
Tel +1 (212) 286-9344 ▮ Fax +1 (212) 856-9420 ▮ www.iesba.org

14 December 2011

Office of the Secretary
PCAOB
1666 K Street, NW
Washington DC
20006-2803

comments@pcaobus.org

Dear Sir/Madam,

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

The International Ethics Standards Board for Accountants (IESBA) welcomes the opportunity to respond to the Public Company Accounting Oversight Board (PCAOB) Concept Release on Auditor Independence and Audit Firm Rotation (Concept Release). Through its standard-setting activities, the IESBA pursues the same objective as the PCAOB, which is to enhance auditor independence and the exercise of integrity, objectivity, and professional skepticism by the auditor.

As an international standard setter of ethics and independence standards for professional accountants, we provide input on proposals of other bodies that have global impact. For example, in December of last year we responded to the EU Green Paper *Audit Policy: Lessons from the Crisis* and we continue to follow its developments closely in order to better inform our own standard-setting agenda. Since the regulations issued by the PCAOB affect the audits of all companies registered with the SEC wherever domiciled, the IESBA believes it is appropriate to respond to the Concept Release.

The IESBA Code of Ethics for Professional Accountants (the Code) recognizes that a threat to professional skepticism is created by the long-association of senior personnel on an audit engagement. The Concept Release explores whether mandatory firm rotation is an appropriate way to address that threat. The IESBA has not debated whether firm rotation is appropriate. The Code, however, mandates rotation of all key audit partners on all public interest entity audit clients (which includes listed entities), unless an independent regulator in the relevant jurisdiction has provided an exemption from partner rotation and specified the alternative safeguards that must be applied. In the IESBA's view, the rotation of key audit partners balances the need for a fresh look on the audit with the need for continuity of knowledge of the client's business and the risks inherent in that business in order to maintain audit quality. It also provides a cost effective way of addressing the threat.

The Concept Release identifies the pros and cons of mandatory firm rotation. If the IESBA were to debate mandatory firm rotation, it would, as an international standard setter, need to consider the costs and benefits of such a requirement in a global context. Given the global reach of the PCAOB's independence requirements, we expect it also will consider the global implications of such a requirement. For example, certain observers suggest that mandatory firm rotation would create inefficiencies and result in additional cost for companies and their investors. Others question whether firm rotation would be feasible at the multi-jurisdictional level. If rotation were required in every jurisdiction in which a company's securities were publicly traded, it appears that audit firms would need to be rotated at a rate determined by the most stringent standard among the jurisdictions in question

In addition, the synchronization of rotation cycles is complicated by partner rotation requirements, if (even within a jurisdiction) firm rotation cycles do not coincide with current partner rotation requirements. For example, under the proposed EU regulation (2011/0359 (COD)), which requires audit firm rotation after six years when there is no joint audit arrangement, senior members of the audit team for an EU-domiciled SEC registrant would rotate prior to the end of the six-year term of the engagement. If the PCAOB were to require audit firms to rotate following a timetable that is different from the EU, the situation would be further complicated, and we suspect there would be no clear improvement in professional skepticism.

Although the academic research on the subject of firm rotation appears inconclusive, if the IESBA were to consider firm rotation, it would likely study that research to determine whether it could better inform the debate. The IESBA also would be interested in understanding why certain jurisdictions that required firm rotation abandoned it.

The Concept Release identifies a lack of professional skepticism as a factor in audit failures[1]. It may be difficult to clearly establish the linkage between a lack of professional skepticism and lack of independence and, in particular, threats created at the level of the firm by long association of professional staff. It may, therefore, be helpful if the PCAOB used its direct access to information about instances of audit failure to conduct a study, perhaps jointly with the International Forum of Audit Regulators (IFIAR), to research any linkage. As a practical matter, the IESBA recommends that all of the issues described above be considered further with input from members of IFIAR.

The Concept Release asks whether there are alternatives to mandatory rotation that would meaningfully enhance auditor independence, objectivity, and professional skepticism. The UK's Auditing Practices Board published a discussion paper "Auditor Scepticism: Raising the Bar" (August 2010), which may be helpful. The paper notes that "Further consideration of aspects of ..... recruitment, training, methodology, and motivation and reward processes may provide opportunities for increased auditor scepticism and, therefore, audit quality."

Strengthening audit committees may also be an effective alternative. The Code encourages regular communication between the firm and those charged with governance. Such communication can be particularly helpful with respect to familiarity threats. In addition, International Auditing Standards, like PCAOB 3526, require such communication, including communication of matters that reasonably bear on the auditor's independence of listed entities.

---

[1] Described in the Concept Release as a situation where the PCAOB's inspection staff determined that, because of an identified error or omission, the firm failed to fulfill its fundamental responsibility in the audit – to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The audit committee has an important role to play in the corporate governance process, including overseeing the audit and satisfying itself of the independence of the auditor. Possible enhancements the PCAOB may wish to consider, in conjunction with other appropriate authorities, to strengthen the audit committee include:

- Requiring term limits for audit committee members, including the chair;
- Strengthening the definition of “audit committee financial expert” (ACFE), including considering whether an ACFE should be a professional accountant;
- Requiring the audit committee of each listed entity to include at least one member who is an ACFE, instead of the current SEC requirement to disclose whether this is the case; and
- Requiring the audit committee to disclose the appointment process for audit committee members

We hope that these comments are helpful to you. If you have any questions, please contact me at 1-973-236-7239.

Yours truly,

Kenneth E. Dakdduk
Chair
International Ethics Standards Board for Accountants

APPENDIX A

Background on IESBA

The IESBA's objective is to serve the public interest by setting high-quality ethical standards, including independence standards, for all professional accountants through the development of a robust, internationally appropriate Code of Ethics for Professional Accountants (the Code). The IESBA develops the Code under a shared standard-setting process involving the Public Interest Oversight Board (PIOB), which oversees the activities of the IESBA, and the IESBA's Consultative Advisory Group (CAG), which provides public interest input into the IESBA's activities, in particular its development of the Code.

The IESBA comprises eighteen members, three of whom are public members. The IESBA is composed of an equal number of practitioners and non-practitioners. A member of the PIOB attends each meeting as an observer. There are three other observers: the Chair of the CAG, a representative from the European Commission, and a representative from the Japanese Financial Services Authority.

In developing the Code, the IESBA adheres to due process as approved by the PIOB to ensure that the decisions reached are in the public interest. The due process includes consideration of issues identified through the IESBA's research in meetings that are open to the public, exposure for public comment of all proposals, and consideration in open meetings of significant issues raised by respondents to the IESBA's exposure drafts.

The Code is widely used by the 167 member bodies of IFAC in more than 127 countries. In accordance with their membership obligations, member bodies are required to have standards that are no less stringent than the standards in the Code. Additionally, firms that are members of 22 accounting firm networks, (the "Forum of Firms") have agreed to have policies and procedures that are consistent with the standards in the Code for all transnational audits. In total, approximately two and half million accountants around the world are subject to the Code.

The Code revised in July 2009, with an effective date of January 1, 2011, adopts a principles-based approach, requiring the evaluation of threats to an accountant's compliance with fundamental ethical principles, which are described in the Code, and the application of safeguards to eliminate those threats or reduce them to an acceptable level.

The Code prohibits accountants from entering into certain interests and relationships and identifies situations where the IESBA has concluded that no safeguards would be sufficient to reduce threats to an acceptable level. Appendix B to this letter contains a high level summary of the conceptual framework approach and many of the prohibitions in the Code that apply to public interest entities.

IESBA INTERNATIONAL ETHICS STANDARDS BOARD FOR ACCOUNTANTS

IESBA Code of Ethics High Level Summary[i] of Prohibitions Applicable to Audits of Public Interest Entities

The 2009 International Ethics Standards Board for Accountants (IESBA) *Code of Ethics for Professional Accountants* (IESBA Code) contains prohibitions, summarized below at a high level, that apply when a professional accountant audits a public interest entity. If a service, interest, or relationship is not covered by one of the prohibitions below, the professional accountant is required to apply the *conceptual framework* set out in the IESBA Code to evaluate it. The conceptual framework entails a rigorous analysis of the service, interest, or relationship from the perspective of a reasonable and informed third party to determine whether it is permissible or should not be entered into because there are no adequate safeguards.

Prohibited Non-Assurance Services

Prohibited Without Regard to Materiality

- Assuming a management responsibility.
- Serving as General Counsel.
- Accounting services*
- Bookkeeping services*
- Payroll services*
- Preparing the financial statements and related financial information.*
- Promoting, dealing in, or underwriting client shares.
- Negotiating for the client.
- Recruiting directors/officers, or senior management who will have significant influence over accounting records or financial statements.
- Evaluating or compensating a key audit partner based on that partner's success in selling non-assurance services to the partner's audit client.

Prohibited if material to the financial statements

- Valuation services
- Calculations of current/deferred taxes.
- Tax or corporate finance advice that depends on a particular accounting treatment/financial statement presentation with respect to which there is reasonable doubt as to its appropriateness.
- Acting as an advocate before a public tribunal or court to resolve a tax matter.
- Internal audit services relating to internal controls over financial reporting, financial accounting systems, or financial statement amounts/disclosures.
- Designing/implementing financial reporting IT systems.
- Estimating damages or other amounts as part of litigation support services.
- Acting as an advocate to resolve a dispute.

* Can be provided to divisions/related entities if routine/mechanical, or in an emergency, if specified conditions are met.

Prohibited Interests and Relationships

- Financial interests in the client.
- Financial interests in an entity in which the client has a material interest, and can significantly influence.
- Loans from a client lending institution that have not been made under normal lending procedures, terms, and conditions, or from a client that is not a lending institution and that are material.
- Material loans to a client.
- Deposits with a client not held under normal terms.
- Close business relationships with a client that are significant or entail a material financial interest.
- Audit team members whose immediate family member is a client director/officer, or an employee able to significantly influence the accounting records or financial statements.
- Former audit team members or a partner joining the client if significant connections with the firm remain.
- A key audit partner or senior/managing partner joining a client before a defined period of time.
- A key audit partner serving for more than 7 years.
- An individual being on the audit team if, during the period covered by the audit, the person was a client director/officer, or an employee able to significantly influence the accounting records or financial statements.
- Partners/employees serving as a client director or officer.
- Contingent fees for an audit or assurance engagement or, when material to the firm, for a non-assurance service to the audit client.
- Accepting gifts or hospitality from the client that are other than trivial and inconsequential.

[i] This high level summary is not a substitute for reading the IESBA Code, which provides details on the application of these prohibitions. Please refer to http://web.ifac.org/publications/international-ethics-standards-board-for-accountants/code-of-ethics.