



**Statement of the Investment Company Institute and the Independent Directors Council  
Hearing on “Legislative Proposals to Relieve the Red Tape Burden on Investors and Job  
Creators”**

**Subcommittee on Capital Markets and Government Sponsored Enterprises  
Committee on Financial Services  
United States House of Representatives  
May 23, 2013**

The Investment Company Institute<sup>1</sup> and the Independent Directors Council<sup>2</sup> are pleased to provide this written statement in connection with the hearing on “Legislative Proposals to Relieve the Red Tape Burden on Investors and Job Creators.” One such proposal, H.R. 1564, the “Audit Integrity and Job Protection Act,” introduced by Representatives Hurt and Meeks, would amend the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act) to prohibit the Public Company Accounting Oversight Board (PCAOB) from requiring public companies to use specific auditors or require the use of different auditors on a rotating basis—commonly known as mandatory audit firm rotation.<sup>3</sup>

ICI and IDC strongly support the legislation.<sup>4</sup> While ICI and IDC support the PCAOB’s focus on strengthening the quality and integrity of the audit process and would be open to considering

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<sup>1</sup> 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 \$14.96 trillion and serve over 90 million shareholders.

<sup>2</sup> 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 ICI-member funds. 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.

<sup>3</sup> In August 2011, the PCAOB published a concept release asking for views on mandatory rotation or other measures to enhance auditor independence, objectivity, and professional skepticism. Concept Release on Auditor Independence and Audit Firm Rotation, PCAOB Release No. 2011-06 (August 16, 2011) (Release). The PCAOB received over 600 comment letters on this proposal, with over 90 percent opposed to it. Since then, the PCAOB held public meetings on the topic in Washington, DC (March 2012), San Francisco, CA (June, 2012), and Houston, TX (October 2012). Again, participants expressed overwhelming opposition to mandatory audit firm rotation.

<sup>4</sup> ICI and IDC submitted comment letters to the PCAOB strongly opposing a mandatory audit firm rotation. *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) (ICI Comment Letter); Letter from Dorothy A. Berry, Chair, IDC Governing Council, to Mr. J. Gordon

alternative proposals, we strongly oppose mandatory audit firm rotation for investment companies (funds). With no empirical 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. Indeed, the PCAOB has not cited any concerns with respect to fund audits, nor are we aware of any. Moreover, there is no clear correlation between any fund audit deficiencies and a lack of auditor independence.

As discussed more fully below, a mandatory audit firm rotation requirement for funds would 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.

### **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. The Investment Company Act of 1940 (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 bolstered these protections.<sup>5</sup> In 2003, the SEC, in implementing various sections of the Sarbanes-Oxley Act, adopted a variety of rules designed to strengthen auditor independence.<sup>6</sup> 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."<sup>7</sup> 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

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Seymour, Secretary, PCAOB, regarding Concept Release on Auditor Independence and Audit Firm Rotation; PCAOB Rulemaking Docket Matter No. 37 (Dec. 14, 2011) (IDC Comment Letter) (together, the Comment Letters).

<sup>5</sup> We note that the SEC's Chief Accountant 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).

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

<sup>7</sup> *Id.*

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.<sup>8</sup> More recently, in its comments on the Release, the GAO indicated that the PCAOB has not provided compelling evidence that the root cause of audit quality issues is related to a break down in auditor independence. The GAO goes on to state that even if such a link could be established, it is unclear that the problem would be prevented or mitigated by mandatory audit firm rotation.<sup>9</sup>

Moreover, fund independent directors provide a critical safeguard with regard to the fund's auditor under the 1940 Act and the rules thereunder. Specifically, the statute requires independent directors to select the fund's auditor.<sup>10</sup> The importance of this responsibility is underscored by the fact that the selection of a fund's auditor is one of only four responsibilities specifically assigned by the 1940 Act to independent directors. 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. 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.<sup>11</sup> The vast majority of fund boards (97%) also have an audit committee financial expert.<sup>12</sup> In addition, fund independent directors 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. This strong oversight mechanism provides ample protection and further renders an audit firm rotation requirement unnecessary.

There also 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.

Finally, there are less onerous mechanisms for continuing to enhance the quality and integrity of fund audits, and IDC and ICI both offered suggestions in our Comment Letters. The IDC Comment Letter encouraged the PCAOB to study ways to improve its communications with and education of audit committee members and the ICI Comment Letter made specific standard-setting

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

<sup>9</sup> See Letter from James R. Dalkin, Director – Financial Management and Assurance, GAO to the Office of the Secretary, PCAOB, regarding PCAOB Rulemaking Docket Matter 037 (December 14, 2011).

<sup>10</sup> Section 32 of the 1940 Act.

<sup>11</sup> See ICI [Report of the Advisory Group on Best Practices for Fund Directors; Enhancing a Culture of Independence and Effectiveness](#) (June 24, 1999).

<sup>12</sup> ICI/IDC [Overview of Fund Governance Practices](#), 1994-2010.

recommendations that could enhance independence, objectivity and professional skepticism.<sup>13</sup> The PCAOB made progress in that regard in August 2012 when it issued a release intended to inform audit committees about its inspection of audit firms and the meaning of reported inspection results.<sup>14</sup> According to the PCAOB, the objective of the release was to better equip audit committees to engage in meaningful discussion with their auditor about its inspection findings. In addition, the PCAOB recently approved an audit standard intended to improve audit quality by enhancing communications between auditors and audit committees.<sup>15</sup> The audit standard establishes requirements that enhance the relevance, timeliness, and quality of the communications between the auditor and the audit committee. Finally, ICI and IDC, in collaboration with a number of other financial organizations, published a tool to assist audit committees, including fund board audit committees, in performing an annual evaluation of the external auditor in order to make an informed recommendation to the board whether to retain the auditor.<sup>16</sup> These developments work to even further promote the quality and integrity of fund audits.

### **Mandatory Rotation Would Likely Have Adverse Effects on Fund Audits**

An audit firm rotation requirement would likely have adverse effects on fund audits. Specifically, mandatory rotation would 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. We do not believe that the PCAOB fully considered the important differences between funds and operating companies with respect to a mandatory audit firm rotation and the impact that such a requirement would have on funds.<sup>17</sup>

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.<sup>18</sup> First, the process of selecting a new audit firm

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<sup>13</sup> See Comment Letters, *supra* note 4.

<sup>14</sup> [PCAOB Release No. 2012-003](#), *Information For Audit Committees About the PCAOB Inspection Process* (August 1, 2012) is available on the PCAOB's website at [www.pcaobus.org](http://www.pcaobus.org).

<sup>15</sup> [PCAOB Release No. 2012-004](#), *Auditing Standard No. 16 – Communications with Audit Committees* (August 15, 2012) is available on the PCAOB's website at [www.pcaobus.org](http://www.pcaobus.org).

<sup>16</sup> *Audit Committee Annual Evaluation of the External Auditor* (October 2012) is available on IDC's website at [http://www.idc.org/pdf/pub\\_12\\_audit\\_eval.pdf](http://www.idc.org/pdf/pub_12_audit_eval.pdf).

<sup>17</sup> The United States Court of Appeals for the District of Columbia vacated the SEC's proxy access rule, finding that with regard to the application of the rule to investment companies, the SEC had failed to adequately address whether the regulatory requirements of the 1940 Act reduce the need for, and hence the benefit from, proxy access for fund shareholders and whether the rule would impose greater costs upon investment companies by disrupting the structure of their governance. *Business Roundtable et. al v. SEC*, No. 10-1305 (D.C. Cir. Decided July 22, 2011).

<sup>18</sup> See [IDC Task Force Paper on Board Oversight of Certain Service Providers](#) (June 2007).

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 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.”<sup>19</sup> 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.<sup>20</sup>

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 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

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<sup>19</sup> 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.

<sup>20</sup> 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. *See* GAO Report, *supra* note 8.

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 SEC regulation imposed by the 1940 Act. In addition, because SEC rules require the auditor to independently verify the valuation of 100 percent of the fund's securities at the balance sheet date, 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.<sup>21</sup> A "deep bench" of audit partners with this expertise is oftentimes necessary for complexes with continuous audit cycles for funds with staggered fiscal years.

Moreover, the prevalence of mutual funds as investment options in 401(k) plans, including those plans offered to audit firm employees, may limit choice in hiring a new auditor. For example, 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 those funds because of the independence issues it would raise.<sup>22</sup> While the audit firm could cause its employees (and their immediate family members) to sell their investments in the funds in order to cure the independence problem, we believe that the audit firm would be unlikely to do so because of the disruption it would cause its employees and their retirement planning. Indeed, we understand that certain audit firms have identified specific fund families that 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. In addition, audit firm personnel may hold investments outside of tax-deferred accounts in those funds and any forced divestment could impose significant tax consequences on the audit firm personnel.

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 more effectively.<sup>23</sup> 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.

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<sup>21</sup> Accounting Series Release No. 118, Investment Company Act Release No. 6295 (December 23, 1970).

<sup>22</sup> 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.

<sup>23</sup> See Release, *supra* note 3.

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

A mandatory audit firm rotation would ignore both the important role of fund boards and their audit committees in overseeing fund audits and 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.

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We appreciate your consideration of our views.