Alliance™ ADVISORS

200 Broadacres Drive, 3rd Floor
Bloomfield, NJ 07003
P: 973.873.7700
F: 973.338.1430
www.allianceadvisorsllc.com

2012 Proxy Season: Audit Firm Rotation

In the wake of the financial crisis, regulators and shareholder activists alike have been revisiting the issue of auditor independence with a view towards requiring companies to periodically rotate their outside audit firms.

The United Brotherhood of Carpenters is filing resolutions for 2012 asking companies to establish a policy that at least every seven years the audit firm rotates off the engagement for a minimum of three years. The Carpenters argue that mandatory auditor rotation would improve the integrity of the audit and ensure the independence of the audit firm's work.

Three of the targeted companies with early annual meetings—Deere, Hewlett-Packard and Walt Disney—are seeking no-action relief on ordinary business grounds. Although the SEC has historically allowed companies to omit shareholder resolutions limiting auditor tenure, the Commission may take into account whether recent regulatory initiatives have elevated the issue to a policy matter engendering widespread public debate.

An August 2011 concept release by the Public Company Accounting Oversight Board (PCAOB) proposes mandatory term limits for corporate auditors in order to enhance their objectivity and professional skepticism. Although the Sarbanes-Oxley Act (SOX) requires registered public accounting firms to rotate the lead and concurring partners on an engagement every five years, PCAOB inspections have found audit deficiencies during the eight years since the Act was adopted. In weighing an appropriate auditor term, PCAOB notes that the average tenure for audit firms is 28 years at the 100 largest U.S. companies (based on market capitalization) and 21 years at the 500 largest U.S. companies.

The European Commission similarly plans to propose legislation this month to address auditor independence, conflicts of interest and audit concentration through measures such as mandatory auditor rotation every nine years, joint audits that include a non-Big Four accounting firm, and audit-only firms.

Critics have long questioned whether mandatory audit firm rotation would be a practical or cost-effective way to strengthen auditor independence. A 2003 Government Accounting Office (GAO) report estimated that for large companies, mandatory auditor rotation would increase audit costs by at least 20% in the first year when the incoming auditor has to gain familiarity with the business of its new client. Consolidation in the industry also makes auditor rotation more complex. Because SOX restricts companies from obtaining various non-audit services from their auditor, they typically have to retain the other Big Four firms to perform those services. Consequently, switching out the audit firm would also result in having to reshuffle the firms providing non-audit services.

PCAOB is seeking comments on its concept release through December 14, 2011 and will hold a public forum on it in March 2012. Although PCAOB is moving slowly on mandatory auditor rotation, issuers would be well advised to weigh in on its release since shareholder activists are likely to continue raising the matter through annual meeting resolutions. See http://pcaobus.org/Rules/Rulemaking/Pages/Docket037.aspx for further information.