June 10, 2004

Mr. Alfred M. Pollard
General Counsel
Office of Federal Housing Enterprise Oversight
Attention:Comments/RIN 2550-AA24,
Fourth Floor
1700 G Street, NW.,
Washington, DC 20552.

RIN 2550-AA24: Proposed Amendments to Corporate Governance Regulation

The American Institute of Certified Public Accountants (the "AICPA") respectfully submits the following comments on the proposed amendments to corporate governance regulation to enhance the minimum corporate governance standards applicable to the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (the "Proposed Rule"). The AICPA is the largest professional association of certified public accountants in the United States, with approximately 350,000 members in business, industry, public practice, government and education.

We support efforts to strengthen corporate governance, including ensuring auditor independence, independent audit committees, code of conduct reviews and improving information flow to Boards for Directors. Throughout its history the AICPA has been deeply committed to auditor independence. It is a core tenet of the accounting profession, which has a more than 100-year history of working to uphold auditor independence. All members of the profession engaged in auditing and attest services are required to maintain independence from audit clients in accordance with detailed and regularly updated independence rules, interpretations and ethics rulings.

The Proposed Rule would prohibit an Enterprise from accepting audit services from an external auditor if either the lead (or coordinating) external audit partner, who has primary responsibility for the external audit of the Enterprise, or the external audit partner, who has primary responsibility for reviewing the external audit, has performed audit services for the Enterprise in each of the five previous fiscal years. We support the OFHEO's objectives underpinning the partner rotation requirement, which is consistent with the independence requirements for auditors of public companies as established in the Sarbanes-Oxley Act.

The Proposed Rule would also require that, at least every ten years, an Enterprise change its external audit firm. In the Proposed Rule, OFHEO observes:

> [OFHEO] has determined that Fannie Mae and Freddie Mac should be required to adhere to certain policies that may not be applicable to all companies but should nevertheless apply to them. Given the importance of having the most impartial oversight and review of accounting and other matters, OFHEO is proposing that the Enterprises should secure a different external audit firm on a periodic basis. To allow a transition, OFHEO would require that Fannie Mae change its external auditor no later than January 1, 2006, and thereafter no less frequently than every ten years; and that Freddie Mac change its external auditor

no later than January 1, 2009, and thereafter no less frequently than every ten years."

The Proposed Rule also correctly notes that public companies are not required to rotate their audit firm. In fact, audit firm rotation was considered by Congress during their deliberations on the Sarbanes-Oxley Act and was not included. Audit firm rotation has significant costs that far outweigh the potential benefits, as government agencies (including the SEC and GAO), private organizations and members of academia previously have concluded.[1] Those costs include:

- *Increase in audit failures.* Studies by the Public Oversight Board (POB), Commission on Auditor's Responsibilities, and the National Commission on Fraudulent Financial Reporting found that audit failures are three times more likely in the first two years of an audit.[2] Thus, there is a positive correlation between auditor tenure and auditor competence.

- *Increased start-up costs.* Changing auditors results in more frequent start-up costs, both for the auditor and the company.

- *Increase difficulties in timely reporting.* Mandatory rotation makes timely reporting more difficult because audit firms need to meet a very short "learning curve" to perform a rigorous audit.

- *Loss of "institutional knowledge."* Over successive audits, audit firms increase institutional knowledge, including, for example, their knowledge of the client's accounting and internal control systems and greater familiarity within the industry in which the client operates. These benefits would be greatly diminished by mandatory rotation, particularly given the unique business model and risks that the Enterprises possess.

- *Opportunity to disguise voluntary rotations.* Companies may use mandatory rotation as a means to disguise problems in the relationship between the company and its auditor, thus

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[1] *See* SEC Office of Chief Accountant, Staff Report on Auditor Independence (1994) (indicating that a periodic change in engagement partners responsible for audits provides a good opportunity to bring "a fresh viewpoint to the audit without creating the significant costs and risks associated with changing accounting firms"); Pubic Oversight Board Advisory Panel on Auditor Independence, Strengthening the Professionalism of the Independent Auditor, (1994) (agreeing with the Cohen Commission's findings concluding that rules mandating audit firm rotation are impractical from a cost/benefit perspective); John C. Burton, *A Critical Look at Professionalism and Scope of Services*, J. of Acct., Apr. 1980 at 50 (recognizing that problems most often occur during the initial audits by an accounting firm); AICPA Commission on Auditor's Responsibility, Report, Conclusions, and Recommendations 108-09 (1978) (finding that the costs of mandatory audit firm rotation exceeds the benefits and suggesting that many of the benefits of audit firm rotation can be achieved through firm personnel rotation). An international study conducted in March 1997 examined the relevant literature on the global auditing profession and the actual experiences in countries that have experimented with mandatory rotation requirements. *See* Benito Arrunada & Candido Paz-Ares, *Mandatory Rotation of Company Auditors: A Critical Examination*, Int'l Rev. L. & Econ. (1997). It noted that countries that have experimented in this area, such as Spain and Greece, have generally resorted back to a traditional market system, whereby companies are free to maintain or change audit firms as they see fit.

[2] The POB's findings are consistent with those of the AICPA's Quality Control Inquiry Control process, which found that allegations of audit failure occur almost *three times as often* when the audit firm is performing its first or second audit of a company.

avoiding the negative marketplace reaction that often accompanies a voluntary change in auditors.

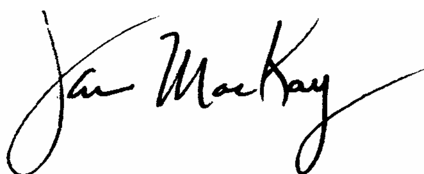
- *Reduced incentives to improve efficiency and audit quality*. Mandatory rotations fail to fully reward firms that achieve greater efficiency and audit quality, because rotation reduces potential demand. Auditors that are less efficient and provide lesser quality services are nevertheless likely to survive because there will constantly be companies looking for new auditors. Conversely, the incentive for each firm to increase its market share and profits would be reduced by the loss of clients after the maximum allowed duration.

Moreover, section 207 of the Sarbanes-Oxley Act mandated that the United States General Accounting Office ("GAO") study the potential effects of requiring mandatory rotation of public accounting firms. The study[3] found that audit firm rotation "may not be the most efficient way to enhance auditor independence and audit quality considering the additional financial costs and loss of institutional knowledge of a public company's previous auditor of record. The potential benefits of mandatory audit firm rotation are harder to predict and quantify, though we are fairly certain that there will be additional costs." (pg. 8) The study also found that "mandatory audit firm rotation is not a panacea that totally removes the pressures on the auditors in appropriately resolving financial reporting issues... These inherent pressures are likely to continue even if the term of the auditor is limited under any mandatory rotation process." (pg. 8)

Ultimately the GAO decided that more experience needs to be gained with the Sarbanes-Oxley reforms to determine if mandatory audit firm rotation is needed. We strongly recommend that OFHEO likewise defer any decision to require audit firm rotation until experience has been gained with the other reforms contained in the proposed rule. The proposed rule contains numerous corporate governance reforms, as well as requiring the rotation of the lead audit partner. Since there are significant definable costs to requiring audit firm rotation, these reforms should be given a chance to work. We strongly recommend that OFHEO not mandate audit firm rotation and monitor the effectiveness of the audit partner rotation requirement and other corporate governance provisions applicable to entities regulated by OFHEO.

We would be pleased to further discuss our comments with OFHEO representatives.

Sincerely,



Ian A. MacKay
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[3] United States General Accounting Office November 2003 report, *Public Accounting Firms: Required Study on the Potential Effects of Mandatory Audit Firm Rotation* (GAO-04-216).