Comments by John C. Bogle,
Founder and Former Chairman of The Vanguard Group
On the Concept Release on Auditor Independence and Audit Firm Rotation

Submitted as Written Testimony for the PCAOB Public Hearing
March 21, 2012

* * *

I'm pleased to have this opportunity to comment on my general views on auditor independence and specific views on audit firm rotation. I have been an observer of and participant in auditing issues throughout my 60-year career, most recently as one of four independent members of the Independence Standards Board (from 1997 to 2001, when it ceased operations), appointed by SEC Chairman Arthur Levitt, where we worked with the four CEOs of the major accounting firms to establish more rigorous standards for assuring that our public accountants remained truly independent of the firms that retain them for attestation services. (As it quickly became obvious, that was no mean challenge!) Earlier in 1991 I was named by SEC Chairman Richard S. Breeden to The Market Oversight and Financial Services Advisory Committee.

In the private sector, as Vanguard's chairman, and earlier, as CEO of Wellington Management Company, I was responsible for recommending the appointment of the auditor for our management company and the mutual funds we manage to our Board, and did not do so casually. Along the way, we replaced our long-time auditor Main & Co., with Price Waterhouse. (No enviable task!) But the process was smooth and essentially cost-free to our firm.

I also served for many years as the Finance Committee chairman and Audit Committee member at papermaker Mead Corporation (now MeadWestvaco); as chairman of the Audit Committee of television network provider Chris-Craft (now part of News Corporation); and as chairman of the Audit Committee at electronic stock market specialist Instinet. It was in that latter post that the firm adapted its accounting procedures to meet the tough and controversial standards of Section 404 of the Sarbanes-Oxley Act on internal controls. (Yes, compliance proved costly and burdensome, but I concluded that the

tough standards established by the Congress were worthwhile. I supported them—as did our board of directors—without reservation.)

My comments on auditor rotation are hardly the stuff of which headlines are made. While I do not believe that mandatory rotation would come close to resolving the plethora of issues surrounding auditor independence, such rotation would be a step in the right direction. "Independence" can be fairly defined as the requirement that "the audit be performed in a disinterested manner, free from influence by the client," and that the auditor should "exercise appropriate professional skepticism and make objective auditing judgments." But meeting that standard will call for much more than mere rotation.

As to frequency of the mandatory rotation, I would think that a formal review of the existing auditor no later than at the 10-year mark of service would be reasonable, and that there should be a flat limit of 20 years for any audit firm's service with a client. While my own audit firm experience was limited to companies whose auditing issues seemed not particularly complex, my conclusion is that concern about the costs of rotation are generally rather exaggerated, and the benefits are understated.

Here, I take the liberty of expressing my strong reservation that the (theoretically wonderful) requirement that a "cost-benefit analysis," a requirement of federal regulators since 1993, is the paragon of common sense. In my experience, cost is usually within the realm of calculation; benefits too often are not. The costs of auditor rotation are wide-ranging and malleable (depending on the interests of those doing the arithmetic). What's to be said about the benefits? Surely our common sense and our instincts do not mislead us when we conclude that the benefits of auditor independence are far-reaching and create substantial (if immeasurable) value for our financial system and our society.

To reach the ideal world of audit independence, the obvious solution is to have the audit firm retained by the providers of the firm's capital, rather than by its managers. (Don't laugh. I'm told that when the canny Scots sent all that capital to America in the mid-18th-century to help build our nation's vast cross country railroad system, they sent their own auditors along.) Today, however, nearly all of our publicly-held corporations have thousands of owners or even hundreds of thousands: One might have thought that as control of our corporations moved from a large group of relatively small individual owners to a small group of relatively large institutional investors, that control might be exercised. Institutional owners—mutual funds, public and private pension funds, endowment funds, trust companies, etc.—now hold 72 percent of all shares of U.S. corporations, up from 8 percent in 1950. The largest 25 of these investor/agents hold 56 percent of all shares—complete control … if they want it.) Perhaps the federal

government should act to arouse these sleeping giants as to the rights and responsibilities of stock ownership.

Until then, I like the section of Sarbanes-Oxley that puts the audit committee—rather than management—in charge of hiring the auditor and overseeing the engagement. That extraordinary latent power is limited by the fact that it is the management that appoints the Audit Committee, and that even the most qualified of audit committee members rarely has the knowledge to analyze the issues—especially the issues *behind* the issues—in depth. Perhaps the Audit Committee should retain its own consultant to assure that the significant issues surrounding the corporation's financial statement receive a full airing. (Management will not easily warm to this idea.)

One of the pressures of the current era is the focus on building "corporate value," so often defined as a focus on the inevitably evanescent short-term stock price. But we all understand that it is the long-term intrinsic value of the corporation we should be focused on. Yes, over the long haul the two must be the same. (Ask Warren Buffett.[1]) But corporate financial statements and reporting often seem fixated on the stock price. It must be obvious that much of the financial engineering that goes on today is only for the here-and-now, and is inevitably zeroed-out over time. But corporate managers are focused on the price of the stock and "earnings guidance" that must be met, lest Wall Street's rancor be incurred.

I have written much on the subject of accounting, and take the liberty of attaching excerpts from my books *Don't Count On It!* (Wiley, 2011) and *The Battle for the Soul of Capitalism* (Yale University Press, 2005), as well as my Seymour Jones Distinguished Lecture at NYU where I served as Henry Kaufman Visiting Professor in 2002. Among the subjects I take on are:

- Operating and pro forma earnings
- The role of public accountants as gatekeepers
- Earnings management
- Pension accounting and return assumptions
- Financial reporting improvements
- Fundamental accounting principles
- Option accounting

[1] In his 1996 letter to shareholders, Warren Buffett said "when the price of Berkshire-Hathaway stock temporarily over-performs or under-performs the business, a limited number of shareholders—either sellers or buyers—receive out-sized benefits at the expense of those they trade with. [But] over time, the aggregate gains made by Berkshire shareholders must of necessity match the business gains of the company."

- Tax shelters

Thank you again for the opportunity to express my views.

These excerpts are included in Attachment A.

John C. Bogle

Enclosure