

August 10, 2015

Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

Re: File Number S7-13-15

Dear Secretary:

This letter represents my comments on the SEC’s concept release (Release), “Possible Revisions to Audit Committee Disclosures.” The opinions are my own and do not necessarily reflect the opinions of my colleagues at The University of Tennessee Haslam College of Business. To provide context to my comments, I was an audit manager at an international accounting firm prior to joining academia, and during that time I gained exposure to the auditor side of the auditor selection process. My dissertation, “Proxy Advisor Recommendations on Auditor Ratification: Who is Listening?,” focuses on the shareholder vote for auditor ratification, and more specifically, the recommendations of proxy advisors.<sup>1</sup> My comments herein focus on Item VI. B., “Audit Committee’s Process for Appointing and Retaining the Auditor.”

In general, I am in strong support of additional disclosures surrounding the auditor selection process. However, before providing specific comments about the proposed disclosures, I would like to point to some data from academic research that may raise questions about the extent to which this information is demanded by shareholders; specifically, data on the shareholder vote for auditor ratification. As summarized in Table 1, academic studies find that, on average, only one to two percent of shareholders vote against the auditor.

**Table 1**  
**Percentage of Shareholders Voting Against or Abstaining From Auditor Ratification**

<b>Source</b>	<b>Median %</b>	<b>Mean %</b>
Cunningham, L. M. 2015. “Proxy Advisor Recommendations on Auditor Ratification: Who is Listening?” Working paper: The University of Tennessee.	1.0%	1.7 %
Dao, M., S. Mishra, and K. Raghunandan. 2008. Auditor tenure and shareholder ratification of the auditor. <i>Accounting Horizons</i> 22 (3): 297–314.	1.1%	1.6%

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<sup>1</sup> Available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2408573](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2408573).

Hermanson, D. R., J. Krishnan, and Z. Ye. 2009. Adverse Section 404 opinions and shareholder dissatisfaction toward auditors. <i>Accounting Horizons</i> 23 (4): 391–409.	1.0%	2.1%
Liu, L-L., K. Raghunandan, and D. Rama. 2009. Financial restatements and shareholder ratifications of the auditor. <i>Auditing: A Journal of Practice &amp; Theory</i> 28 (1): 225–240.	1.3%	2.1%

While it is not clear what the expected level of dissent should be, on average, I would expect that more than one to two percent of shareholders experience some level of dissatisfaction with their auditor because of material misstatements, significant PCAOB inspection deficiencies, and ‘missed’ material weaknesses or going concern opinions. Therefore, I propose two alternative explanations for the low level of dissent. First, low levels of dissent may suggest that the overwhelming percent of shareholders are not dissatisfied with, or do not significantly care about, the company’s choice of auditor, in which case it does not appear that these additional disclosures would benefit shareholders. Second, low levels of dissent may suggest that there is insufficient information available to shareholders to make the voting decision, in which case additional disclosures may substantially benefit shareholders.<sup>2</sup> Based on archival data currently available, we cannot disentangle these two possible explanations. Therefore, before requiring these additional disclosures, I would encourage the Committee to think about which explanation is driving shareholder voting behavior. My hope is that the collection of comments received on this section of the Release, particularly those comments from shareholders, provide some insight into this issue. But if it does not, the SEC could consider sponsoring a survey of shareholders to better understand the issue before mandating the disclosures.

As for the specific questions posed in the Release, Section VI. B., see my responses below. For those questions in Section B not listed below, I did not feel that I had sufficient experience in the matter to provide commentary.

26. What types of disclosures could be made regarding the process the audit committee undertook to evaluate the external audit and performance and qualifications of the auditor, including the rationale for selecting or retaining the auditor?

28. If audit quality indicators are used in the evaluation of the auditor, should there be disclosure about the indicators used, including the nature, timing, and extent of audit quality indicators considered by the audit committee? If audit quality indicators are not used in the evaluation of the auditor, what, if any, disclosures regarding the assessment of audit quality should be provided?

Response to 26 & 28: The audit committee should disclose in general terms the audit quality indicators (AQIs) that it considered in determining whether the

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<sup>2</sup> A third alternative is that the auditor ratification vote does not effectively capture the shareholders’ opinions of the auditor selection decision, but that is beyond the scope of my commentary here.

engagement quality was sufficient enough to continue the auditor relationship (for retained auditors) or the key factors used in selecting the audit firm (for newly selected auditors). Here, I do not think that specific numbers are necessary, but I do think it would be helpful for shareholders to understand in broad terms which AQIs the audit committee thinks are most pertinent to monitoring the ongoing quality of the audit and how often the committee monitors these AQIs. This information will allow shareholders to better understand the audit committee-auditor monitoring process.

29. What types of disclosures could be made about requests for proposals for the audit, including the process undertaken and the factors considered in selecting the audit firm?

30. Should there be disclosure as to whether the audit committee sought proposals for the audit (including the reason the request for proposal was made), or whether the audit committee has a policy in this regard?

31. Would additional disclosures in this area provide meaningful additional information with respect to the selection of the auditor? If so, what types of disclosures should the Commission require to be made in this regard? For example, in addition to disclosure of whether there is a policy about shareholder ratification, should there also be disclosure of the factors the board considered in establishing the policy?

Response to 29 - 31: Shareholders would first benefit from understanding the 'selection set' of audit firms that are equipped to audit the company. There are hundreds of audit firms registered with the PCAOB and yet the majority of companies continue to use the Big 4 and other international audit firms. There may be valid reasons for doing so, including availability of specific industry or geographic resources. However, in a recent paper I coauthored with Kenneth Bills and Linda Myers, from the University of Arkansas, we find that associations, networks, and alliances may be a valid resource to allow small audit firms to provide these resources.<sup>3</sup> Specific disclosures could include:

- 1) The characteristics that the audit committee looks for when screening potential audit firm candidates (e.g., size, office locations, industry or technical expertise, etc.).
- 2) When the audit committee last solicited requests for proposals (RFP).
- 3) The number of audit firms that provided an RFP in the most recent solicitation that passed the screening process for potential audit firm candidates.
- 4) The primary characteristics that warranted the specific auditor selection in the most recent solicitation (refer to Response to 26 & 28 here).

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<sup>3</sup> See Bills, K. L., L. M. Cunningham, and L. A. Myers. 2015. Small Audit Firm Membership in Associations, Networks, and Alliances: Implications for Audit Quality and Audit Fees. *The Accounting Review* In-Press.

32. If there are a significant number of votes against the ratification, and the board nevertheless proceeds with the auditor in question, should the audit committee report provide the reasons why the board determined to go forward with that auditor? If not in the audit committee report, where should this information be provided and when should it be provided?

Response to 32: I do not think it necessary to mandate this type of disclosure because other monitoring mechanisms provide incentives for board members to voluntarily do so. In particular, proxy advisors (such as Institutional Shareholder Services and Glass Lewis) typically recommend voting against board members if they are nonresponsive to shareholder dissent.<sup>4</sup> Further, I have concerns about the difficulty of defining “significant” specific to the auditor ratification vote, and thus, the ability to monitor compliance with such a disclosure. For example, only 14 out of 6,373 auditor ratification votes filed between January 2012 and September 2013 (0.02 percent) had shareholder dissent in excess of 25 percent, and more than 80 percent of votes received less than two percent dissent.<sup>5</sup> Based on discussions with audit partners, Dao et al. (2012) suggest that dissent as low as five or ten percent could raise questions about the auditor.<sup>6</sup>

In summary, assuming that the SEC obtains evidence that shareholders are in need of additional information surrounding the auditor selection process (from other Release commentary or survey results), I am in strong support of enhanced disclosures for: 1) the characteristics of a qualified audit firm, 2) the available set of qualified audit firms (which can be inferred from the number of qualified firms submitting an RFP), 3) when the audit committee last solicited for proposals, and 4) the audit committee’s process for evaluating ongoing audit quality. Thank you for the opportunity to comment on this release.

Sincerely,



Lauren M. Cunningham, PhD, CPA  
Assistant Professor  
University of Tennessee  
Haslam College of Business  
Department of Accounting and Information Management

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<sup>4</sup> See Institutional Shareholder Services, Inc.’s “2015 U.S. Summary Proxy Voting Guidelines,” Item 2.2 Responsiveness of Board of Directors.

<sup>5</sup> See Pakaluk, J. 2013. “Auditor Ratification: Shareholders Appear Content.” AuditAnalytics.com (October 21).

<sup>6</sup> See Dao, M., K. Raghunandan, and D. V. Rama. 2012. Shareholder ratification of the auditor, audit fees, and audit quality. *The Accounting Review* 87 (1): 149–171.