

June 11, 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**

Dear Mr. Pollard:

KPMG LLP (“KPMG”) respectfully submits the following comments on the proposed corporate governance regulations to enhance the minimum corporate governance standards (the “Proposed Rule”) applicable to the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (the “Enterprises”).

KPMG supports efforts to improve corporate governance, including recent legislation and rulemakings that have strengthened the roles of management, directors, auditors, and regulators in order to increase investors’ confidence in the capital markets.

The Proposed Rule’s Section 1710.18 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 recommend that OFHEO’s final rules require compliance with the existing SEC rules, regulations, and interpretations regarding independence and partner rotation. That would avoid multiple, and potentially conflicting, versions of independence and rotation rules.

In addition, OFHEO is proposing that the Enterprises change their external audit firms “no less frequently than every ten years.” For the reasons discussed in more detail below, KPMG believes that mandatory rotation of audit firms would increase, not decrease, the risk of audit failure, as well as cause significant disruption and substantial costs to the Enterprises without the perceived offsetting benefits. In addition, the audit process would be burdened by substantial start-up time and a steep learning curve each time firms are rotated, thereby possibly detracting from the quality of the audit effort in critical audit areas.

There is ample evidence upon which our belief is based. As recently as November 2003,<sup>1</sup> a broad study of mandatory rotation by the United States General Accounting Office (GAO), noted that “*Mandatory audit firm rotation may not be the most efficient way to enhance auditor independence and audit quality, considering the costs of changing auditors and the loss of auditor knowledge that is not carried forward to the new auditor.*” The GAO study also reports that 90% of audit committee chairs of surveyed Fortune 1000 companies oppose mandatory rotation of public accounting firms, citing the risk of audit failure, the higher costs, and audit inefficiencies.

Thirty years of study by public commissions, private organizations and members of academia go beyond the cautionary note that the GAO sounded, finding that rotation has significant risks and costs that outweigh the perceived benefits.<sup>2</sup>

Our concerns include:

- ***Increase in Audit Failures and Fraud.*** Studies by the Cohen Commission and the AICPA have found that audit failures are up to three times more likely in the first two years of an audit, when auditors are less familiar with a company’s operations.<sup>3</sup> A January 2004 study from the University of Tennessee notes that “there is a significant positive relation between short auditor tenure and fraud, and no significant relation between long tenure and fraud.”<sup>4</sup> It is well known that frequent changes of auditors by a public company is a “red flag” warning signal for possible fraud, because managements intent on committing fraud are well aware that new auditors are less familiar with a company’s operations and less likely to detect a fraud. Mandatory rotation has the potential to replace that “red flag” warning with the cloak of a “legitimate” change of auditors.

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<sup>1</sup> 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).

<sup>2</sup> See Commission on Auditors' Responsibilities' *Report, Findings, and Recommendations* (1978) chaired by former SEC Chairman Manuel Cohen; Public Oversight Board Advisory Panel on Auditor Independence, *Strengthening the Professionalism of the Independent Auditor*, (1994); Carcello and Nagy, *Audit Term Tenure and Mandatory Rotation*, January 2004; Testimony of SEC Chairman Harvey Pitt, House Financial Services Committee, March 20<sup>th</sup>, 2002 “What [firm rotation] might produce are worse audits rather than better audits. You would have audit firms that weren’t as familiar with the companies they were auditing and would be more susceptible to not catching fraud than they would otherwise.”

<sup>3</sup> See *Strengthening the Professionalism of the Independent Auditor; Report, Findings, and Recommendations*, "(I)n the Commission's study of cases of substandard performance by auditors, several of the problem cases were first- or second-year audits. While not conclusive, this indicates the higher peril associated with new audit clients. Once an auditor becomes well acquainted with the operations of a client, audit risks are reduced. If a relationship between audit failures and new clients does exist, rotation would increase the problem and be detrimental to users". In addition, research conducted by the AICPA’s SEC Practice Section in the US into over 400 cases of alleged ‘audit failure’ between 1979 and 1991 indicate that the alleged failures occurred almost three times as often when the auditor was performing its first or second audit of the company, as compared to the third and subsequent audits.

<sup>4</sup> Carcallo and Nagy, p. 21

- ***Rotation is Disruptive and Costly:*** Each time rotation occurs, an entity faces the significant disruption, expense, and time involved in retaining new auditors. The entity also loses any advantages and efficiencies gained by retaining an auditor who knows the business and the people.
- ***Limited Choice.*** The Enterprises may have very limited choices when forced to rotate firms. The Proposed Rule would apply to only two entities. An Enterprise may not wish to engage the same auditors as its primary competitor. That leaves the Enterprise with only two large firms from which to choose. If the entity has engaged one or both of those firms for services that would impair that firm’s independence as an auditor, then the Enterprise’s choice of replacement firms would be even more limited. This concern was shared by the American Assembly in their recent report entitled “The Future of the Accounting Profession.”<sup>5</sup>

We believe the perceived benefits of firm rotation are achieved by partner rotation, without creating the audit and independence risks described above. Rotating the engagement and reviewing partners is critical to providing a “fresh look” at any audit, because the engagement partner plays the most important role in the design, scope, implementation, and the final conclusions of the audit. If there is a need for consultation about a particularly difficult or evolving accounting treatment, or area of risk or uncertainty, the largest accounting firms have established specific protocols and processes as a part of the quality control system to assist the engagement partners in reaching the appropriate conclusions on these issues. One such element of the quality control system is the national office function (at KPMG, we refer to this function as our Department of Professional Practice). Our Department of Professional Practice, which includes both partners and senior managers on rotation from practice offices and a limited number of permanent partners, provides consultation and assistance to the engagement partner in reaching the appropriate conclusions. Issues raised by the engagement partner to the Department of Professional Practice are assigned to professionals in the Department based on their knowledge of the subject matter. These subject matter professionals draw upon their knowledge of the applicable literature, and emerging interpretations by standard-setters and regulators, plus their operating office and similar experiences, in assisting the engagement partner with a particular issue. Rotation of personnel at the engagement level (and within our Department of Professional Practice), provides fresh perspectives on an audit without sacrificing the deep institutional and accounting knowledge that exists throughout an audit firm.

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<sup>5</sup> *The Future of the Accounting Profession*, Report of the 103<sup>rd</sup> American Assembly chaired by former SEC Chairman Roderick Hills (November 13-15, 2003): “[T]he Sarbanes-Oxley Act prohibits accounting firms from providing many non-audit services to their audit clients. As a result, multinational companies typically engage two of the Big Four—one to provide audit services and the second for non-audit assignments. That means if directors later wish to change auditors, it has only two firms available from which it may pick. If one of those audits a direct competitor and the second of those lacks sufficient expertise, management and directors are left with few options, other than taking the drastic step of switching both its audit and non-audit engagements - a move which may put the former advisory firm in the uncomfortable position of auditing its own work. Assembly participants found no ready answer to this quandary, despite extensive discussion and a significant degree of concern.”

In 1974, Robert K. Mautz, Vice Chairman of the Public Oversight Board and Professor Emeritus of the University of Illinois and the University of Michigan noted that “the auditor well acquainted with the client has an advantage not compensated for by new-broom alertness.” We believe that 30 years of empirical data continue to support this assertion, and that the ever-increasing complexity of financial reporting makes his argument even more compelling.

Therefore, while KPMG strongly supports OFHEO’s proposal to mandate the rotation of the audit and reviewing partners consistent with existing SEC rules, regulations and interpretations, we respectfully recommend that OFHEO not mandate audit firm rotation, as we believe the risks are greater than the perceived benefits of such a requirement.

If you have any questions, we would be pleased to further discuss our comments with OFHEO representatives. Please feel free to call Mr. Samuel J. Ranzilla at (212) 909-5837.

Very truly yours,

KPMG LLP