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The Sarbanes-Oxley Act Ten Years Later

Auditor Independence, Objectivity and Professional Skepticism

PCAOB Investor Advisory Group
Working Group Presentation
March 28, 2012

A Public Responsibility

“In certifying the public reports that collectively depict a corporation’s financial status, the independent auditor assumes a public responsibility ... [That auditor] owes ultimate allegiance to the corporation’s creditors and stockholders, as well as to the investing public. This ‘public watchdog’ function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.”

-- United States v. Arthur Young (1984)

Independence: Why It Matters

“The independence requirement serves two related, but distinct, public policy goals. One goal is to foster high quality audits by minimizing the possibility that any external factors will influence an auditor's judgments . . . The other related goal is to promote investor confidence in the financial statements of public companies . . . Investors are more likely to invest, and pricing is more likely to be efficient, the greater the assurance that the financial information disclosed by issuers is reliable. The federal securities laws contemplate that that assurance will flow from knowledge that the financial information has been subjected to rigorous examination by competent and objective auditors.”

SEC Auditor Independence Requirements

Independence: Why It Matters

- An audit that lacks independence, objectivity and professional skepticism has no value. Investors can't rely on its findings.
- As we move toward more principles-based standards and greater reliance on judgment, auditor independence becomes all the more important.
- The fact that auditors are hired and compensated by the audit client creates a major conflict of interest.
- Auditor independence rules are designed to minimize that conflict, mitigate its effects, and promote objectivity and professional skepticism in the conduct of the audit.

A Long History of Concerns

- In 1977, in the wake of massive scandals at Penn Central and other prominent public companies, a Senate subcommittee chaired by Sen. Lee Metcalf published a study of the American "accounting establishment."
- Sen. Metcalf expressed grave concern over "the alarming lack of independence ... shown by the large accounting firms." Large firms have not fully accepted the special responsibilities which accompany the position of independent auditor," the report found.
- The Metcalf report highlighted concerns related to both non-audit services and the long tenure of audit engagements that "may lead to such a close identification of the accounting firm with the interests of its client's management that truly independent action by the accounting firm becomes difficult."

A Long History of Concerns

- In the 1980s, Rep. John Dingell, then Chairman of the House Energy and Commerce Committee, held hearings that he said “showed the auditing business was fraught with conflicts of interest that posed a danger to investors.”
- In 1994, the SEC issued a report on auditor independence in response to a congressional request. That report said no “fundamental changes” were needed at that time.
- Over the course of the 1990s, however, the Commission appears to have grown increasingly concerned about threats to both auditor independence and the quality of financial reporting.

New Pressure to Make the Numbers

- In a September, 1998 speech entitled “The Numbers Game,” then SEC Chairman Arthur Levitt described how pressure to match Wall Street earnings estimates was undermining the quality of financial reporting:

“Increasingly, I have become concerned that the motivation to meet Wall Street earnings expectations may be overriding common sense business practices. Too many corporate managers, auditors, and analysts are participants in a game of nods and winks. In the zeal to satisfy consensus earnings estimates and project a smooth earnings path, wishful thinking may be winning the day over faithful representation.”

Growing Importance of Consulting

- At the same time, audit firms had undergone a dramatic transformation over the course of several decades, with firms' consulting arms playing an increasingly dominant role within audit firms.
- Consulting services had become increasingly important to audit firms' bottom line, and the ability to cross-sell consulting services had become increasingly important to auditors' compensation and career advancement.
- In 1999, U.S. consulting revenues for the Big Five firms totaled more than \$15 billion, accounting for roughly half of total revenues. By way of contrast, consulting revenues had constituted just 13 percent of total revenues in 1981.

Growing Importance of Consulting

- When companies first began making mandatory disclosures of fees paid for audit and non-audit services in 2001, the growing importance of consulting to firm bottom lines was starkly illustrated.
- A 2001 report found that large companies reported paying their audit firm \$2.69 in consulting fees for every \$1 in audit fees.
- In some cases, the disparity was much greater:
 - KPMG had billed Motorola Inc. \$3.9 million for auditing and \$62.3 million for other services.
 - Ernst & Young had billed Sprint Corp. \$2.5 million for auditing and \$63.8 for other services.
 - PricewaterhouseCoopers had billed AT&T \$7.9 million for auditing and \$48.4 million for other services.

Changing Culture at Audit Firms

- In an August, 2003 speech called “Accounting Professionalism – They Just Don’t Get it,” Arthur R. Wyatt, a former Managing Director at Arthur Andersen explained:

“Firm leaders not only failed to recognize how the widening range of services was impairing the appearance of their independence, but they also failed to recognize how the emphasis on increasingly conflicting services was changing the internal culture of the firms. Consulting revenues had relegated the traditional accounting and tax revenues to a subsidiary role.”

Changing Culture at Audit Firms

- With the growth of consulting services came a growing focus on revenue growth and profit margins and a change in the culture of audit firms. Wyatt described it this way:

“Auditors were more willing to take on additional risk in order to maintain their revenue levels ... Clients were more easily able to persuade engagement partners that their way of viewing a transaction was not only acceptable but also desirable ... Healthy skepticism was replaced by concurrence. The audit framework was undermined, and the result was what we have recently seen in massive bankruptcies, corporate restructurings, and ongoing litigation.”

A Rising Tide of Restatements

- In the five years from 1997 through 2001, nearly 1,000 companies had to issue restatements, according to published reports at the time.
- In 2000, 157 companies issued restatements, up from 33 in 1990.
- In 2001, the number had risen to 233, double what it had been just three years earlier.

The SEC Responds

- Over the course of the 1990s, the SEC began to raise concerns about both particular consulting services that they felt created conflicts that threatened auditor independence and the large amount of money firms were earning from non-audit services.
- In July, 2000 the SEC proposed rules to limit the consulting services that audit firms could offer to audit clients, modernizing its rules on financial interests in, and employment relationships with, audit clients, and adding an express prohibition on auditors' receipt of contingent fees from their audit clients.
- The major accounting firms and the AICPA launched a massive lobbying campaign against the proposal, which included soliciting opposition from members of Congress.

The SEC Responds

- Some members of Congress responded by writing letters in opposition to the proposed rules and by threatening to cut off funding for the effort if the SEC persisted in moving forward.
- Ultimately, the lobbying campaign against the rules had its effect and the rules were watered down.
 - Certain consulting services, including internal audits and financial system design, were removed from the list of prohibited services.
 - Exceptions and loopholes were introduced into the definitions of other prohibited services.
 - Principles governing determinations of auditor independence were removed from the text of the rule and placed in a preliminary note, lessening their prominence and undermining their enforceability.

Enron and Auditor Independence

- The sudden collapse of Enron at the end of 2001 brought renewed attention to the long-simmering issue of auditor independence.
- The case highlighted many of the characteristics that had previously raised concerns about auditor firms' declining independence, objectivity and professional skepticism.
 - Extensive evidence emerged that Arthur Andersen had been aware of Enron's questionable accounting for years and may even have helped to design some of the transactions used to keep debt off the company's balance sheet.
 - The account was viewed as too big to risk losing, producing revenues of \$52 million and expected to produce as much as \$100 million in the near future.

Enron and Auditor Independence

- Andersen had for a number of years served as both internal and external auditor for Enron.
- Andersen had served as Enron's auditor since 1985 and maintained permanent office space in the Enron building.
- Over the years, there had been a constant flow of employees from the accounting firm to Enron. Both Enron's chief financial officer and its chief accounting officer were Andersen alumni.
- Enron employees described a chummy atmosphere in which employees were so intermingled it was hard to tell who worked for whom.
- In short, Arthur Andersen's audit of Enron was independent in name only.

Similar Conflicts Were Pervasive

- Other high-profile accounting scandals of the era were marked by similar conflicts of interest.
 - Transcripts from a lawsuit following the accounting failure at Pharmor Inc. showed its Coopers & Lybrand auditor received bonuses and performance evaluations based at least in part on his ability to cross-sell the firm's non-audit services.
 - After MicroStrategy was forced to disavow years of financial statements, it was revealed that a senior PricewaterhouseCoopers manager assigned to the audit was applying for a job at a MicroStrategy subsidiary while working on the audit.

Similar Conflicts Were Pervasive

- In the Waste Management accounting scandal, in which the SEC charged Arthur Andersen with repeatedly signing off on financial statements it knew to be misleading:
 - Arthur Andersen had been the company's auditor for 30 years.
 - From 1971 to 1997, all of the company's Chief Financial Officers and Chief Accounting Officers were former Andersen auditors.
 - The partner assigned to lead the audit was responsible for coordinating marketing of non-audit services and was compensated based on the volume sold.
 - Andersen was billing Waste Management more than twice as much for non-audit work as it was for the "independent" audit.

SOX and Auditor Independence

"The issue of auditor independence is at the heart of this legislation. Public confidence in the integrity of financial statements of publicly traded companies is based on belief in the independence of the auditor from the audit client."

Report of the Senate Committee
on Banking, Housing and Urban Affairs
June 26, 2002

SOX and Auditor Independence

- Title II of the Sarbanes-Oxley Act is devoted to the issue of auditor independence. Among its provisions are:
 - Strengthened rules on prohibited activities, codifying and expanding on existing auditor independence rules
 - Audit committee pre-approval of audit and non-audit services
 - Mandatory audit partner rotation
 - Auditor reports to audit committees of critical accounting policies and practices to be used, alternative treatments discussed with management, and other material written communications
 - Cooling off period (1 year) before auditor can serve in a key management position at an audit client (e.g., CEO, CFO, controller or chief accounting officer)
 - GAO study of mandatory audit firm rotation

SOX and Auditor Independence

- Provisions dealing with auditor independence also appear in other sections of the legislation. Among them:
 - Audit committees are made responsible for appointing and paying the auditor and overseeing the conduct of the audit, including resolving any conflicts with management
 - A provision making it illegal for the issuer to exert improper influence on the auditor or audit
 - Strengthened independence and financial expertise requirements for audit committees
 - PCAOB responsibility to establish and adopt auditor independence standards, inspect firms for compliance, and discipline firms for violations

What SOX Didn't Do

- Several other auditor independence reforms were strongly backed in congressional testimony, but were not adopted in the final legislation. These included:
 - A broad ban on non-audit services
 - Mandatory rotation of audit firms
 - Third-party appointment of auditors
 - A more robust cooling off period covering a wider range of management positions and imposing a longer cooling off period

SOX Implementation

The SEC Adopts Rules

- When it came time to implement the legislation, accounting firms renewed their efforts to weaken key components of the reforms. In implementing the rules, the SEC bowed to audit firm pressure in several important areas.
 - On the central issue of audit committee pre-approval of non-audit services, the SEC not only allowed approval through policies and procedures, a concession Congress had refused to provide, but affirmed that explicit approval and approval based on policies and procedures were equally acceptable.
 - The Commission removed any suggestion from final rules that audit committees should carefully evaluate non-audit services in light of established independence principles.
 - In implementing the requirement that audit committees include a financial expert, the Commission adopted a weak definition of financial expert.

SOX Implementation

The SEC Adopts Rules (cont.)

- The Commission also responded to audit firm and AICPA lobbying in several other areas.
 - The Commission backed off its initial proposal to add heft to the audit partner rotation requirement by adding a “cooling off” period before audit team members could rotate back onto the audit and by extending the requirement to all professional members of the audit team.
 - The Commission revised fee disclosure rules in ways that obscured the magnitude of conflicts. They allowed a number of services not directly related to the audit to be included in the audit fee category, and they re-characterized a number of other non-audit services as audit-related.
 - While the Commission made numerous concessions to the audit firms, they ignored all investor suggestions to improve the rules.

SOX Implementation

Investor Concerns are Justified

- Soon after the rules were implemented, evidence quickly emerged that at least one leading firm was exploiting loopholes in the rules to evade requirements for pre-approval of non-audit services. A document came to light in which Ernst & Young was advising clients to implement the pre-approval requirement by:
 - Rubber-stamping whole categories of services
 - Suggesting that the SEC did not intend audit committees to consider the principles of auditor independence in reviewing non-audit services
 - Encouraging audit committees to group virtually all non-audit services in the audit or audit-related fee categories when calculating whether fees for non-audit services create an unacceptable conflict

PCAOB and Auditor Independence

- The Sarbanes-Oxley Act gave the newly created PCAOB three additional tools to use to promote auditor independence, objectivity and professional skepticism.
 - The PCAOB was given standard-setting authority, including authority to adopt independence and quality control standards.
 - The PCAOB was given inspection authority, including authority to require remediation of audit deficiencies.
 - The PCAOB was given enforcement authority, including the authority to impose fines and revoke registration.
- The PCAOB has used all three tools to promote improvements in audit quality.

PCAOB Adopts Independence Rules

- In 2003 the PCAOB adopted interim independence standards based on the AICPA Code of Conduct and the Independence Standards Board. In doing so, the Board made clear that these standards did not supersede SEC standards and, where the two sets of standards were inconsistent, the more restrictive standard would apply.
- In 2006 the PCAOB adopted additional independence rules related primarily to tax services. The rules:
 - Prohibit firms from providing advice to clients about tax shelters and other potentially abusive transactions
 - Prohibit firms from providing tax services to certain executives of audit clients responsible for overseeing financial reporting
 - Prohibit contingent fee or commission compensation of audit firms
 - Add requirements for disclosure to audit committees regarding pre-approval of non-prohibited tax services

PCAOB Enforcement Actions

- Since being established, the PCAOB has taken a total of 47 enforcement actions that have resulted in sanctions' being imposed on audit firms and accounting professionals.
- Of those 47 actions, 27 involved violations relating to professional skepticism and 4 involved violations of independence standards.
 - In three cases involving both independence and professional skepticism violations, the auditing firm's registration was revoked and the accounting professionals involved were barred from association with a public company.
 - Violations related to professional skepticism generally involved the failure of audit professionals to perform sufficient audit procedures necessary to verify assertions made by management in financial statements.

PCAOB Enforcement Actions

- Other examples of violations that resulted in enforcement actions included:
 - Raising the quantitative materiality threshold, despite believing that original materiality threshold level was appropriate, so that known misstatements could be treated as immaterial.
 - Allowing management to control the confirmation process.
 - Failing to perform sufficient audit procedures relating to the valuation, presentation, and classification of research and development costs.
 - Accepting last-minute adjustments by company management that in effect offset an overstatement in assets and revenues without questioning whether the last-minute adjustments warranted further investigation.

PCAOB Enforcement Actions

- The majority of actions brought by the PCAOB resulted in the revocation of the registration of the accounting firms involved, with some of the firms having the right to reapply after a certain period of time.
- Actions involving Big Four firms resulted in censures and monetary penalties against the firms.
- Other sanctions imposed against firms included restrictions on activities and the requirement to implement enhanced compliance procedures.
- The majority of actions brought by the PCAOB resulted in the engagement partner or other person in charge of the audit being barred from association with a registered public company.
- Other sanctions against accounting professionals included temporary suspensions (typically one year) and monetary penalties.

Problems Persist

- Despite evidence of improvements in audit quality, the PCAOB “remains concerned about both the frequency and the type of audit deficiencies it continues to find.”
- According to a recent report on inspections of the large audit firms between 2004 and 2007, inspectors continue to find deficiencies in important audit areas.
 - These deficiencies occurred in audits of issuers of all sizes, including in some of the larger audits they reviewed.
 - In some cases, the deficiencies appeared to have been caused, at least in part, by the failure to apply an appropriate level of professional skepticism when conducting audit procedures and evaluating audit results.
 - Audits in which inspectors faulted the firms’ application of professional skepticism and objectivity included some of the larger audits inspected.

Problems Persist

- In congressional testimony last year, PCAOB Chairman James R. Doty expressed similar concerns based on results of the 2010 inspection cycle.
- Inspectors have continued to identify serious deficiencies related to:
 - Valuation of complex financial instruments
 - Inappropriate use of substantive analytical procedures
 - Reliance on entity level controls without adequate evaluation of whether those processes actually function as effective controls
 - And more
- Inspectors have found deficiencies to be on the rise and to persist in areas previously identified by the Board.

Problems Persist

- Marketing materials also raise questions about objectivity and professional skepticism. In making proposals to prospective clients, one of the largest audit firms:
 - Described the auditor as “a partner” whose role was to support and help the issuer achieve its goals.
 - Suggested that they would “stand by the conclusions reached” and not “second guess our joint decisions.”
- The Board has expressed concern that, “as a more general phenomenon, this kind of mindset may have affected firms’ public company audit work.”

Problems Persist

- Recent inspection reports provide additional evidence that audit firms may be adopting an insufficiently objective mindset. For example:
 - “[The inspection results] suggest that the audit partners and senior managers ... may have a bias toward accepting management’s perspective, rather than developing an independent view or challenging management's conclusions.”
 - “In a number of engagements, the [firm’s] support for significant areas of the audit consisted of management’s views or the results of inquiries of management. The lack of professional skepticism appears to stem from the [firm’s] culture that allows, or tolerates, audit approaches that do not consistently emphasize the need for an appropriate level of critical analysis and collection of objective evidence.”

Problems Persist

- The PCAOB is not alone in raising these concerns. Other audit oversight bodies have identified similar problems.
 - The United Kingdoms’ Audit Inspection Unit found that firms “sometimes approach the audit of highly judgmental balances by seeking to obtain evidence that corroborates rather than challenges the judgments made by their clients.”
 - They have called on auditors to “exercise greater professional skepticism particularly when reviewing management’s judgments relating to fair values and the impairment of goodwill and other intangibles and future cash flows relevant to the consideration of going concern.”
 - According to Australia’s Securities and Investment Commission, its audit inspection program has identified a number of instances that raise concerns about the auditors’ judgment, and the level and attitude of professional skepticism.

Problems Persist

- In Germany, the auditor oversight commission has raised concern that, in some cases, audit partner evaluation and compensation practices emphasized “economic and acquisition aspects” over “performance incentives to secure the audit quality.”
- In analyzing audits by the Big Four firms, the Netherlands Authority for the Financial Markets has identified a number of instances in which the firms “failed to exercise sufficient and appropriate professional scepticism in the conduct of their audits.”
- Based on its findings, the AFM has concluded that “a fundamental change of conduct is necessary to improve the quality of audits.”

Regulators Respond

- In the wake of the financial crisis, the European Commission has launched an “evaluation of the role and effectiveness of auditors and potential policy responses.”

“Many banks revealed huge losses from 2007 onwards on the positions they had held both on and off balance sheet. Many of them have been aided by the Member States (and, *in fine*, the taxpayer) ... In this context, it is difficult for many citizens and investors to understand how auditors could give clean audit reports to their clients (in particular banks) for those periods. If indeed these reports were justified because current legislation is such that it allows clean audit reports in spite of acute intrinsic financial weaknesses in the audited entity, then the role of the audit as well as the scope of audit merit further discussion and scrutiny.”

Commission Staff Working Paper Impact Assessment, Nov. 30, 2011

Regulators Respond

- In its analysis of the role of auditors in the financial crisis, the European Commission has identified impaired professional skepticism and undermined independence of audit firms as key drivers of audit quality problems.
- They attribute this to three main causes:
 - Provision of non-audit services
 - The issuer-pays business model
 - The threat of familiarity “that results from the audited company often appointing and re-appointing the same audit firm for decades”
- The Commission is considering a variety of reforms with regard to audits of systemically important institutions, including mandatory rotation, audit-only firms or limitations on non-audit services, and measures to improve audit committee oversight.

Regulators Respond

- Meanwhile, the PCAOB issued a concept release on auditor independence in August, 2011 “to solicit public comment on ways that auditor independence, objectivity and professional skepticism could be enhanced.”
- A central focus of that concept release was mandatory audit firm rotation.
- As of mid-March, the Board had received 630 comment letters, and the comment period remains open until April 22.
- The Board also held a two-day roundtable on ways to enhance audit firm independence, objectivity, and professional skepticism, including through audit firm “term limits.”

Views on Current Policies

- The vast majority of commenters seem to agree that the Sarbanes-Oxley Act's combination of enhanced audit committee responsibility for oversight of the audit, improved communication between auditors and audit committees, and PCAOB inspection and remediation authority had improved the quality of audits and financial reporting.
- Beyond that broad agreement, significant differences in viewpoint are evident.
 - Some commenters, particularly among audit firms, appear to believe only relatively minor tweaks to the existing approach are needed.
 - Others argue for more extensive revisions to enhance auditor independence, objectivity and professional skepticism, but within the general context of the current system.
 - A few see evidence of a need for more radical change.

Views on Current Policies

- The following comments are generally representative of the view that the current system is generally working well:
 - "Auditor independence and objectivity have improved as a result of audit committees' oversight of performance. Limitations of non-audit services to audit clients have reduced the potential for, or appearance of auditor conflicts of interest. Audit partner rotation has increased objectivity. And the creation of the PCAOB itself has led to enhanced audit quality through both its inspection program and standard setting efforts." – Robert E. Moritz, U.S. Chairman and Senior Partner, Pricewaterhouse-Coopers LLP
 - "We believe audit quality has improved in recent years, and the Board and profession should seek to build on this foundation ..."
– Stephen R. Howe, Jr., a Managing Partner with Ernst & Young

Views on Current Policies

- At the other end of the spectrum, several commenters suggested that the current client-pays system is fundamentally incompatible with true auditor independence.
 - “From the perspective of auditor psychology, the question before the board is easy and obvious. Of course the current system undermines auditor independence. Indeed, the very notion that the current system allows for truly independent audits is laughably implausible.” – Don Moore, Haas School of Business, University of California at Berkeley
 - “Auditors’ interests are currently aligned with management’s because of the ‘client-payer’ model. Nominally, shareholders approve the hiring of an auditor based on the audit committee’s recommendation. That’s the extent of their involvement, however.” – Jack T. Ciesielski, CPA and CFA, R.G. Associates, Inc.

Views on Current Policies

- In the middle ground are those who see the need for significant changes to the current system, but not necessarily a dramatic departure from the current client-pays system.
 - For example, noting that during there financial crisis, “there were far too many incidents where the audit firms did not insist on full disclosure of risks and material weaknesses of their biggest clients,” former Comptroller General Charles A. Bowsher said, “it is very timely and somewhat overdue that the SEC and PCAOB consider additional issues that would further strengthen auditor independence in addition to ones enacted in the Sarbanes/Oxley legislation.”

Views on Current Policies

- Among them were commenters who highlighted specific areas in which the current system appears to be falling short.
 - Arnold Wright, Joseph M. Golemme Research Chair at Northeastern University's College of Business Administration, cited research indicating management, rather than audit committees plays the dominant role in decisions to hire and fire the auditor.
 - Steven E. Buller, Managing Director, BlackRock, Inc., said they see evidence "that some firms continue to expand their advisory practices into areas that are less aligned with traditional audit and tax practices."

Views on Audit Firm Rotation

- Commenters' views on mandatory audit firm rotation divide along similar lines.
 - Some commenters – particularly audit firms, audit committee members, and issuers – expressed strong opposition to mandatory rotation.
 - Other commenters – particularly some former regulators and investors – expressed strong support for mandatory rotation.
 - A third group argued that mandatory rotation was not adequate to address the problem.

Views on Audit Firm Rotation: Pro

- A number of commenters expressed strong support for mandatory rotation, either on its own or in combination with other policy changes to promote auditor independence, objectivity and professional skepticism.
 - Former Comptroller General Bowsher said mandatory rotation for the biggest clients of the Big Four firm was the most important improvement the PCAOB could make. “We have debated if for over 30+ years. The last 10 years have provided more than enough evidence that it should be adopted.”
 - Former SEC Chairman Arthur Levitt said, “Investors deserve the perspectives of different professionals every so often, especially when an auditor’s independence can be reasonably called into question.”

Views on Audit Firm Rotation: Pro

- Peter Clapman, Chairman and President of Governance for Owners USA, Inc. said: “Unless, the PCAOB takes the regulatory action to require auditor rotation, the status quo, which encourages “Audit firm for life or forever, which ever comes first,” will continue and investor concerns about audit firm independence will persist.”
- Having participated in three auditor rotations, Clapman said the results were “better audits, similar costs, and none of the dire consequences being argued by many of the commentators against the PCAOB concept release.”
- Among supporters of mandatory rotation, the key benefits cited are that a new auditor would bring a fresh viewpoint to the review of financial statements and that limiting audit tenure would increase auditors’ willingness to resist pressure from management.

Views on Audit Firm Rotation: Pro

- Among those who offered support for mandatory rotation were a number who suggested it should be just a first step in a broader reform agenda.
 - For example, John C. Bogle, founder and former chairman of The Vanguard Group, said: “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.”
 - Professor Richard L. Kaplan of the University of Illinois, Urbana-Champaign, said: “Mandatory audit firm rotation would not by itself solve the problem of auditor independence in a world in which auditors are hired, fired, and paid by the company they are auditing ... But such rotation would fundamentally improve the situation and would counter to some degree the natural tendency of accounting firms to identify with their clients.”

Views on Audit Firm Rotation: Pro

- Advocating an approach that combines mandatory rotation, a ban on all non-audit services, and greater limits on auditors’ ability to go to work for audit clients, Max H. Bazerman, Jesse Isidor Straus Professor of Business Administration at Harvard Business School, put it this way:

“The choice should not be between the status quo (which the auditing industry has invested many millions of dollars in lobbying efforts to create) and the reforms being proposed. Rather, the choice should be between whether our society wants independent audits or whether it does not. If we do want independent audits, it is time to recognize that, without a massive overhaul of the existing system, this goal will elude us. Society is currently paying enormous costs without getting the very service that the industry claims to provide: independent audits.”

Views on Audit Firm Rotation: Con

- A number of commenters, including all the Big Four accounting firms expressed strong opposition to mandatory rotation.
- The key arguments against mandatory rotation are that it would impinge on the authority of audit committees, increase costs and disruption, and undermine audit quality during the transition to a new auditor.
 - Fairly typical of the arguments put forward by the accounting firms was the comment from Center for Audit Quality's Cindy Fornelli, who said: "Mandatory firm rotation would limit the statutory authority of audit committees to hire and fire the auditor, engender cost and disruption for issuers, cause a scarcity in the choice of auditors for certain sectors and for global companies, and have a potentially negative impact on audit quality."

Views on Audit Firm Rotation: Con

- Buller said BlackRock's corporate audit committee, analysts and management "are concerned about restrictions in a company's ability to select the most qualified audit firm, the loss of institutional knowledge and the reduced incentive for audit firms to invest in the audit relationship when their time horizon is short."
- Former SEC Chairman Roderick M. Hills expressed particular concern over the diminished role for audit committees that would result: "Many have pointed out that it would be expensive to force auditor changes and that the quality of the audit will certainly deteriorate for the first year or two of a new auditor's work. I agree. However, first and foremost of the reasons to reject the notion of mandatory rotation is that such a requirement would substantially reduce the authority and the role of audit committees."

Views on Audit Firm Rotation: Con

- Others expressed more specific concerns about the workability of mandatory rotation.
 - For example, noting that rotation would be good for some companies and bad for others, former SEC Chairman Richard Breeden said: “The level of concentration of audit firms limits the practical choices of all audit committees, and means that rotation now would be much more difficult than it might have been 20 years ago.”
 - Another former SEC Chairman, Harvey Pitt, said: “Large accounting firms are not fungible; one firm is not identical to another, and there can be valid market-driven reasons, such as expertise in a certain industry, for selecting and retaining one firm over others.”

Views on Audit Firm Rotation: Con

- A few of those who opposed mandatory rotation did so because they did not believe it would be effective.
 - For example, Jack T. Ciesielski said: “Well-intentioned as it is ... I don’t believe that required auditor rotation addresses the root cause of objectivity problems within the audit profession. The root cause is that auditors’ interests are aligned with management, and not aligned with the interests of shareholders. Simply changing the auditors every few years only treats the symptom of the problem, and not the cause ... I recommend that the Board should try to align the interests of auditors with shareholders in more fundamental ways.”

Alternative Approaches

- A variety of proposals were offered as an alternative to mandatory rotation.
 - Some commenters suggested adjustments to the mandatory rotation proposal with an eye toward making it more effective or more workable.
 - Alternatives put forward by the accounting firms tended to involve relatively minor tweaks designed to strengthen the current system.
 - Several commenters suggested alternative approaches based on a requirement that audit committees put the audit out for rebid on a more frequent basis.
 - A few offered suggestions for addressing the client-pays business model.

Alternative Approaches

- The following are among the variations on mandatory rotation that have been suggested.
 - Require audit firm rotation for the largest financial institutions and other large industry-leading companies as well as large companies with auditing or accounting problems.
 - To address the “learning curve” problem, require a dual audit by the two firms in the year preceding the transition.
 - Require a change of auditors in limited circumstances, such as financial statement fraud.
 - Require the departing auditor to report to the Board of Directors, investors, the PCAOB and the SEC on the overall condition of the financial statements and systems and controls.
 - Require auditors to be hired under fixed contracts that stipulate the term of rotation, during which time the client would not be permitted to fire the audit firm.

Alternative Approaches

- The following are among the changes that generally involve tweaks to the existing system.
 - Improve the independence of audit committees by removing management from the selection of board members.
 - Improve the expertise of audit committee members either by strengthening financial expertise requirements or by empowering audit committees to hire consultants to aid in their evaluation of financial reporting issues.
 - Expand auditors' communication with the audit committee, along the lines currently being considered by PCAOB.
 - Permit PCAOB inspectors to discuss inspection results on a confidential basis with audit committee members.
 - Improve auditor training.
 - Require disclosure on the proxy of audit firm tenure.

Alternative Approaches

- Tweaks to the existing system (continued)
 - Initiate PCAOB actions that would increase understanding of and compliance with expectations regarding auditor independence, objectivity, and professional skepticism.
 - Create audit quality councils to advise audit firms.
 - Require early and direct guidance from the audit committee in fee negotiations to reinforce the representation of shareholder interests.
 - Define an expanded scope for the audit committee report on its auditor oversight and move the report from the proxy statement to the Form 10-K to enhance its timeliness and prominence.
 - Increase disclosure to shareholders concerning a change in independent accounting firm, beyond the current requirement to report on disagreements between the audit firm and the company, to include more information on the audit committee's decision.

Alternative Approaches

- Tweaks to the existing system (continued)
 - Require that each firm auditing the financial statements of more than 100 public companies publish an annual report describing the firm's system of quality control, the steps it takes to safeguard independence, the basis for audit partner compensation, and the firm's governance and legal structures
 - Promote more direct involvement by the audit committee in approving the audit partner replacing a rotated partner.
 - Provide disclosure to audit committees by the independent accounting firm of any pending PCAOB enforcement proceeding in which the firm or any of its partners is a respondent.
 - Implement a system whereby audit committees could request the PCAOB to perform an enhanced inspection of the audit of their company, with reporting of results to both the company and its auditors.

Alternative Approaches

- The following are among the suggestions that have been offered involving more frequent rebidding of audit contracts.
 - Under an approach suggested for former SEC Chairman Breeden, the PCAOB would establish a rebuttable presumption that, after 10 years, auditor independence is impaired.
 - At that time, the audit committee would either have to rotate audit firms or explain why it had chosen not to do so in light of the presumed loss of independence.
 - For the largest audits, the PCAOB would conduct an inspection in the seventh year and require rotation if the Board finds serious problems with objectivity and independence.
 - Where no problems are identified, the audit committee would have the option of continuing with the incumbent firm for an additional term, at which point the process would begin again.

Alternative Approaches

- Former SEC Chairman Pitt offered a similar suggestion, as follows:
 - Audit committees would be required to consider (and document) whether the performance of auditors over a prescribed period of time (e.g., five years) warranted reappointment.
 - The PCAOB and/or SEC would specify the types of data the audit committee should gather and the types of judgments the audit committee must make.
 - The audit committee would be required to articulate its decision in writing, and publish the information in an easily accessible form for its shareholders and regulators to see.
 - Audit committees would be required to dismiss their auditors where the PCAOB or the audit committee concluded that there were indicia of insufficient auditor skepticism or where they found serious deficiency in audit quality.

Alternative Approaches

- Former SEC Chairman Hills suggested the following refinements to an approach that would require audit committees to regularly consider replacing the external auditor.
 - He said audit committees “should on occasion seek independent assistance in determining whether the ‘scope’ of the audit that is proposed is appropriate, whether the hours proposed to be spent on the audit are reasonable, and whether the quality of personnel assigned to the audit is adequate.
 - In addition, he said, audit committees should be required to have firm rules that give them complete oversight of any non-audit work that the external auditing firm performs.

Alternative Approaches

- The following are among the alternatives suggested to replace the client-pays business model.
 - Bogle suggested consideration be given to an approach in which the mutual funds, public and private pension funds, endowment funds, and trust companies that own the bulk of stock in public companies would be organized to take greater responsibility for retaining the audit firms.
 - Ciesielski offered the most elaborate such suggestion, which would create a system of financial statement insurance. Under this approach, financial statement issuers would purchase financial statement insurance that covers investors against losses resulting from financial reporting misrepresentations.

Alternative Approaches

- Ciesielski offered the following arguments in favor of this approach.
 - By transacting with the insurance company, the issuing firm would have a direct interest in the quality of the reporting process: the more confidence the insurer can place in the financial reporting process of the insured, the lower the premiums they should need to charge the issuer.
 - The insurer wants to minimize losses so as to preserve profitability of the financial statement insurance product and will charge what it needs to obtain comfort that it won't lose; the issuer will want to make its reporting as clean as possible in order to prove to the insurer that it deserves the lowest possible premium.
 - This is a transparent, market-driven mechanism that rewards virtuous reporting – and the insurer effectively stands in the shoes of the investors.

Alternative Approaches

- Financial statement insurance (continued)
 - Insurers are already willing to provide insurance against risk of loss from events over which they have no control whatsoever. In offering financial statement insurance, they'd be insuring events where they could actually exert influence on the outcome of events.
 - Facing the threat of losing revenue for many audits as a consequence for doing a poor job on just one engagement would be a far more powerful auditor motivation than existing legal consequences in the form of shareholder lawsuits.

Will This Time Be Different?

- For several decades, regulators have at various times suggested policy changes to enhance auditor independence, objectivity and professional skepticism.
- In each instance, the biggest audit firms have strongly opposed the proposed reforms and have often been successful in beating back those reform efforts.
- It took a wave of massive accounting scandals at the start of the last decade to provide the impetus for the passage of the Sarbanes-Oxley Act, including its independence reforms.
- Ten years later, observers generally seem to concur that the system has improved, but many remain concerned that additional improvements are needed.
- Evidence during and since the financial crisis seems to support that concern.

Will This Time Be Different?

- Two quotes from media accounts of accounting scandals of their day offer ideas to contemplate as we consider how best to move forward on this issue:
- The first is from a Washington Post editorial during the deliberations over SOX.

“There is a price to regulation. When you tell companies not to hire their auditors [as consultants], you may distort the job market; when you force them to rotate audit firms, you impose real costs. But the efficient allocation of capital depends on accurate bookkeeping, and the books won’t be accurate so long as auditors remain conflicted or corrupt ... In this contest between audit firms’ business models and the public’s interest in disclosure, surely somebody will take the public’s side?”

Will This Time Be Different?

- The second quote comes from a recent column by Jonathan Weil regarding the scandals at MF Global and Olympus:

“So many large companies have blown up after getting the all-clear from a Big Four accounting firm that many people regard auditor opinion letters as a joke ... The biggest fear for the Big Four cartel should be that someday investors will become so fed up that they demand the status quo be chucked entirely, figuring they’ve got nothing left to lose. We’re not there yet, but give it time. If the auditing profession can’t figure out a way to re-instill value in its most basic product, even terrible solutions may start to look like drastic improvements.”

Discussion Questions

- How well has the Sarbanes-Oxley Act worked to improve auditor independence, objectivity and professional skepticism?
 - Limits on non-audit services
 - Audit partner rotation
 - Audit committee oversight of the audit
 - PCAOB inspection, remediation and enforcement
- How could the existing system be improved?
- Do you think mandatory rotation would be effective in enhancing auditor independence?
- How do you view the various alternatives put forward?
 - More frequent rebidding of the audit
 - Financial statement insurance

Future Research

- Our working group has begun developing a survey in order to gather additional investor views on these issues.
 - What do you see as the most important issues for that survey to cover?
 - To whom should the survey be administered?
 - How can the survey data be most usefully submitted?