

October 31, 2011

Office of the Secretary  
PCAOB  
1666 K Street, N.W.  
Washington, D.C.  
20006-2803

**Re: PCAOB Rulemaking Docket Matter No. 37 (Audit Firm Rotation)**

We are writing with respect to the PCAOB's call for comments regarding mandatory rotation of audit firms by public companies. This letter is written by a group of academics and business executives based in the US and Canada. The authors of this letter are as follows:

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## **PCAOB Rulemaking Docket Matter No. 37 (Audit Firm Rotation)**

We understand and affirm the importance of auditor independence, objectivity and scepticism for the proper functioning of the U.S. capital market and are supportive of the PCAOB's desire to enhance the actual and perceived independence of auditors. However, academic research on the topic suggests that adopting a system of audit firm rotation will not help the U.S. economy achieve these worthy goals. Instead, such a change may impair auditor independence, weaken audit expertise and undermine corporate governance.

We organize our response below in terms of impact on objectivity (especially opinion shopping), and development of expertise. We note that many of the views expressed in our letter are influenced by a detailed research study conducted by Fiolleau et al. (2010) on how companies currently choose auditors. A copy of this study is publicly available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1535074](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1535074). Of course, any such study is limited in its generalizability. In particular, Fiolleau et al. (2010) examines cases where audit committee's have voluntarily chosen to seek competing bids from auditors. However, we think the studies' observations are suggestive of what is likely to happen on an economy-wide basis if PCAOB were to mandate periodic rotation of audit firms. Some of our other comments are based on other research evidence, which we cite.

Selection and appointment of auditors by their clients is a major source of concerns about real and perceived independence and objectivity of the auditors. Since the PCAOB seems to be unwilling to deal with this root cause of the independence problem at this time, other reforms are being sought. No audit can be perfect, and the quality of audit is determined not only by independence but also by many other factors—such as the quality of accounting standards, accounting education, auditor expertise, audit committees, corporate governance, auditor discipline, liability, and a host of other institutional features of the audit environment. The focus of PCAOB should be to provide the best audit quality, and not to fixate on any subset of such determinants of audit quality. Our reading of existing research leads us to conclude that, in spite of its superficial appeal, audit firm rotation is a bad policy choice on all relevant dimensions. We explain our reasons below.

### **Rotation and Auditor Objectivity**

The most appealing and common sense intuition underlying auditor rotation is that it promotes objectivity by refreshing the personnel (or firm) who are not tied down by judgments, compromises, and personal relationships of the past. A new auditor brings a fresh set of eyes, and has the opportunity to raise issues that have been overlooked or settled in the past. Research experiments show that new auditors are better able to identify issues, alter their judgments, and bring issues up for discussion when they are not personally committed to prior decisions (see article by Tan on p. 113-35 in Spring 1995 issue of Journal of Accounting Research).

Our first observation on this rationale for firm rotation is that familiarity arises between individuals (e.g., the audit partner and the CFO) not firms, so most of the benefit from taking a “fresh look” can be obtained more simply by rotating the partner and or other senior personnel on the audit team (e.g., audit manager). Since the policy of partner rotation is already in place, audit firm rotation is unlikely to add any significant marginal benefit, especially when the

considerable costs of firm rotation are taken into account. The GAO's (2003) study on mandatory audit firm rotation estimated increased initial audit costs of more than 20% (some studies in Europe suggest 40%) and this did not include costs incurred by the audit committee and management to conduct the tendering process.

Our second observation from the research study by Fiolleau et al. (2010) is that although the auditors are supposedly appointed by the audit committee of the client company, management plays a significant role in the process, and may even dominate it for all practical purposes. This means that a mandate for audit firm rotation will force the incumbent and potential auditors into a "beauty contest" every few years. The market power of the audit firms is so much weaker than the power of their clients that, at the time of bidding for engagement, the former compete among themselves to convince the management / audit committee of their potential clients of their commitment, service, and responsiveness. Each hiring exercise becomes an opportunity for opinion shopping by clients, lowballing of audit fees and demonstrations of loyalty and relationship-building by the auditors. Many of the auditor behaviours that the rotation proposal is intended to discourage get exacerbated when the audit firm enters into a beauty contest (bidding war) to get an audit engagement.

A third observation from the Fiolleau et al., (2010) study is that, with only four large international firms, the audit market is highly concentrated. Most large clients already receive one service or another from every one of the four firms. If one of these accounting firms audits the client, the other three often provide it a host of advisory services in tax, valuations etc. This perpetual engagement and pre-existing relationships of most large companies with all four audit firms implies that there is only limited opportunity for mandatory rotation to bring about a "fresh look." A large corporation would have to deliberately avoid business engagement with one Big 4 firm, to have at least one firm who would meet current independence rules and have the expertise needed to conduct the audit. The PCAOB proposal is likely to yield little by way of benefits and incur the additional harm associated with increased frequency of "beauty contests."

### **Rotation and Auditor Expertise**

There is compelling evidence that audit firm rotation will impair auditor expertise. PCAOB's concept paper indicates awareness that the auditor is most vulnerable to missing fraud in a new engagement (see also St Pierre and Anderson on p 242-63 in Vol 59(2), 1984 issue of The Accounting Review). A variety of studies (e.g., Myers et al., on p 779-799 in Vol 78, July 2003 issue of The Accounting Review) show that the quality of accounting numbers improves with increases in auditor tenure. The most compelling force disciplining accounting accruals is auditor industry expertise (see Craswell et al., on p 297-322 in December 1995 issue of Journal of Accounting and Economics). While academic evidence is seldom conclusive, the weight of evidence suggests that a policy of mandatory auditor rotation undermines expertise formation and will impair audit quality. The thrust of Generally Accepted Accounting Principles (GAAP) is increasingly oriented to having management communicate to investors how they operate the business. Auditors' understanding of the substance of client business would be undermined if they are rotated out every few years. The Fiolleau et al (2010) study reveals that even the four largest audit firm's lack depth of expertise in serving large corporate clients across all industries outside the main business centres such as New York, Toronto, London, and Tokyo. For clients

with headquarters located in smaller cities, finding industry specialists in the local offices can be a significant challenge.

### **Improving Audit Quality**

Audit quality is not just an attribute of the auditor alone. The nature of Generally Accepted Accounting Principles (GAAP) is also a major determinant of audit quality. Over the recent decades, the Financial Accounting Standards Board (FASB) has set standards that de-emphasize verifiability in favour of the mark-to-market valuation, no matter how illiquid the market may be. It has also adopted a practice of writing detailed standards in its attempt to close loopholes but ends up creating new ones. Exploitation of the Repo 105 rules by financial service firms during the recent crisis is a good example. This type of standards place auditors in a very difficult position vis-à-vis corporate management. The shift in GAAP towards the so-called “fair value accounting” is a major factor undermining audit quality.

### **Importance of Audit Resignation as a Signal**

When financial press reports that company X audited by firm Y for the past twenty years has changed its auditor, investors get a valuable and informative warning signal that draws close scrutiny by the investment and regulatory communities. PCAOB’s mandatory rotation proposal will eliminate this signal by making auditor changes a matter of routine, deserving little attention or scrutiny, and thus undermine the quality of audit.

### **Transfer of Audit Resources from Verification to Marketing**

The PCAOB proposal, by eliminating all long-term client-auditor relationships, will induce audit firms to devote even greater resources to marketing themselves to potential clients. These resources can only come from cutting back on the substantive work of verification during the course of their audits or by raising audit fees. Individuals in the audit firm will find their presentation and marketing skills becoming more valuable relative to their technical accounting and auditing skills.

### **Confusion and Unintended Consequences from Too Many Initiatives**

Auditors now face a very complex economic and social environment. There are economic incentives to be responsive to management but these have to be balanced with incentives emanating from audit committees, concurring review partners, national office reviews, litigation, GAAP and industry practice, and PCAOB reviews. In some countries two audit firms jointly conduct an audit making it difficult for any single audit firm to have consistency in its audits across countries as complex co-ordination is required across audit firms. Fraud cases like Parmalat are thought to have avoided detection due to lack of continuity of the auditor and presence of multiple audit firms. Adding more agents and incentives into this mix serves to create a very complex incentive structure, interpersonal friction and potential for unintended consequences as accountability and authority get distributed across a variety of agents. This increases moral hazard and the potential for confusion. Adding one more firm rotation requirement on top is not just a free good that improves the system. Too much complexity makes the audit process more vulnerable to systemic failure.

## **Conclusion**

Audit firm rotation is a bad policy prescription especially in an environment where auditors are appointed by board audit committees who often are significantly influenced by management. The potential benefits of rotation will be exceeded by the harm associated with the “beauty contest” that takes place to appoint a new auditor. Rotation actually impairs audit quality by promoting more frequent opinion shopping and lowballing. Rotation also impairs audit expertise, eliminates a valuable signal of auditor change, and shifts even more resources from substantive audit work to marketing of audit services.

Most of the benefits of rotation can be realized by rotating the engagement partners. Because of limited depth of expertise, we suggest rotating engagement partners every ten years. Given the limited independence of most audit committees from the management, PCAOB’s goal of improving audit quality through firm rotation is beyond its reach. Pressing the FASB/IASB to pay greater attention to verifiability of financial reports would be a more effective avenue to improve audit quality.