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To: Public Company Accounting Oversight Board members

Re.: Rule making docket No. 37

December 14, 2011

I would like to commend the members of the PCAOB for releasing 2011-006, Concept Release on Auditor Independence and Audit Firm Rotation. My goals in this comment letter is to summarize academic research on the influence that the current institutional arrangements have on auditor judgment that appear to be consistent with what the Board inspectors have found during their inspections about audits (pp. 7-9). This literature is not referenced as part of the set of academic studies that the Board refers to on pp. 16-17 and I believe is important for the Board to be aware of when interpreting what their inspectors have observed. I will also add a short comment about the Board's discussion of their evidence about audit failures and that the Board's reluctance to generalize from it may be overly cautious.

Overall, I conclude that the Board's concerns are on the right track and that there needs to be continued focus on enhancing auditor independence, objectivity and professional skepticism. However, the focus on such issues may not lead to the solution contemplated "audit firm rotation." I note that the Board in its Appendix A has taken note of the controversy about the need for an independent private sector style audit (i.e. the current institutional arrangements) during Senate testimony regarding the original SEC Act of 1933. It is possible that other approaches considered at that time, including creating an independent audit unit that would randomly carry out in depth audits of companies as part of the Federal Trade Commission (or some other government authority) might be revisited. That is combine the best features of today's regime with the ability of an independent government institution to carry out in depth audits of clients perhaps when the audit firm audits of particular clients are questioned by the PCAOB. In other words, take advantage of the well-known aversion of US firm management to avoid government intervention into their businesses by making them the ones that insist on high quality audits.

Conceptually, this would result in the auditors being given strong motives by their client's management to uphold the "accuracy" of financial statements to avoid government intervention into their business. Furthermore, this recommendation is consistent with my diagnosis of what is at the heart of the current audit malaise, the auditor taking the very nature course of seeing all, but

the most extreme violations of GAAP, through the eyes of client management as a motivated reasoner. If management is demanding more “accurate” financial statements to keep the long arm of the government out of its business, then the auditor is more likely to have and take to heart a goal of enhanced financial reporting accuracy as the auditor’s motives would be aligned with those who pay him – firm management.

## **PCAOB Inspectors Observations (pp. 7-9) and Academic Research**

PCAOB inspectors document a number of concerns that are discussed in the Board's release on auditor independence. These concerns have been reflected in the academic audit research literature yet do not appear as part of the Board's set of academic research referred to later in the report. Below I summarize each concern and discuss related academic research on it.

### **1. Proposals to client firms p. 7**

The Board documents a case where the language used in proposals are inconsistent with the auditor being in an independent state of mind by asserting "Your auditor should be a partner in supporting and helping (the issuer) achieve its goals . . . ." and "Support the desired outcome where the audit team may be confronted with an issue that merits consultation with our National Office." There are several research studies that have been carried out both in the USA and in Canada about how audit firms approach new clients and the role of the local office partner relative to consultations with technical experts at the firm's National Office.

Examining the engagement proposal process, Fiolleau, Hoang, Jamal and Sunder (2010) obtained access to details of five audit proposals in Canada as well as corroboration from a US Big 4 partner in charge of proposals in that country that there was nothing atypical about what the authors observed in the Canadian proposal process that would not happen in the USA. Fiolleau et al document that in the proposal process the winning auditor disregarded the tender requirements to involve more expert auditors in the audit and instead provided a quote on a low cost low expertise audit that was accepted despite the stated criteria. Furthermore, they document that the language the PCAOB inspectors describe was typical of what they found in the various firm's proposals for the audits. While this study is currently still in working paper form, it has been accepted for presentation at numerous referred conferences and is well along in the academic peer review process. Furthermore, published papers by Gendron (2001 and 2002) employing field based interviews document similar observations in his study of new client acceptance procedures by Canadian Big X firms. Further, he documents that these practices are considered ultra-secretive by US Big X firms (Gendron 2000). After Gendron asked for then Big 6 firm access to carry out his research and after some firms first agreed to meet with him, it became apparent that the firms had consulted with each other and then agreed not to allow such research to proceed.

Examining the role of the National Office, Salterio (1994, 1996) and Salterio and Denham (1997) employ field interviews with audit partners and managers at both the local and national offices of a most of the Big 5 firms in Canada as well as one firm in the USA. Furthermore, they had extensive access to as well in-firm documentation. They discuss the tendency of the local office partners to want the National Office to provide precedents/advice that would support the desired client's position. Indeed, Salterio (1994) documents that in the firm he studied that potential precedents that did not support the client's preferred accounting were routinely not provided to practice offices as that would not be good customer service to the practice office. In all cases, whether it was the provision of precedents or technical accounting advice, the emphasis was on finding corroboration for what the client wanted not looking for "best" accounting or an independent assessment of the circumstances.

2. Board describes inspection findings that document examples of potential failure to exercise professional skepticism and objectivity by auditors in the field including a bias towards accepting management's perspective pp. 7-8

There is a long line of academic research that suggests the client preferences for certain accounting are directional goals for auditors and that in light of these goals they focus on collaborating what the client wants in its accounting rather than what might be the most appropriate accounting. This is called in the academic literature "motivated reasoning."

This research dates back more than twenty years in underlying psychology research. Indeed, the first systematic summary of that literature states the following:

I propose that people motivated to arrive at a particular conclusion attempt to be rational and to construct a justification of their desired conclusion that would persuade a dispassionate observer. They draw the desired conclusion only if they can muster up the evidence necessary to support it. In other words, they maintain an "illusion of objectivity". Kunda (1990 p. 482-483)

Notice that Kunda is not saying that motivated reasoners set out to distort the evidence but in the presence of a directional goal they are motivated assess the evidence so as to derive a conclusion that they believe would persuade a "dispassionate observer" that their conclusion about the directional goal is correct.<sup>1</sup>

Accounting researchers have documented judgments by auditors consistent with motivated reasoning. Among the participants in these studies include a large number of audit partners and managers as well as lesser ranked audit firm personnel. Among the issues examined are:

- When auditors know in advance what their superiors in the audit firm desire as a conclusion from an audit procedure or evidence evaluation they attempt to provide it unless it results in patently unsupportable positions being taken (e.g., Peecher, Mark E., et al. (2010) and Wilks (2002)).
- Blay documents that how auditors interpret evidence about client going concern issues is dependent on the threat level that they perceive that they will lose the client if a going concern qualification is issued. Evidence is judged as much more favourable to the client when there is a strong threat of auditor replacement than when that threat is not there without any changes to the underlying case facts (e.g., Blay, (2005)).
- Hackenbrack and Nelson (1996) document that even the wording of accounting standards is interpreted differently by auditors who are confronted by clients who want a certain interpretation of the standard to be applied to their transactions.
- Ng and Tan (2007) document when the client expresses concerns over a quantitatively immaterial adjustment that may have qualitative implications auditors are more likely to interpret the evidence as client management wishes unless there are explicit offsetting pressures.

<sup>1</sup> Kunda (1990) also elaborated on another branch of the motivated reasoning research which she denoted as the "accuracy goal." However, this research has not focused on how the accuracy goal can be made paramount in the presence of a directional goal (Mishra et al., 2008 JCR).

- Salterio and Koonce (1997) show that as soon as a set of precedents provided by the National Office of a firm is no longer unanimously against what the client desires, the auditor interprets those precedents consistent with what the accounting the client wants irrespective of what the auditor thinks is the most appropriate accounting.
- Asare et al. (2009) investigate the question whether client relations goals affect auditor judgment. They find that auditors with client relations goals (i.e. to satisfy client management) are more likely to accept clients' preferred accounting method however a heightened litigation consciousness reduces but does not eliminate this effect
- Wolfe, Mauldin and Diaz (2009) document that management persuasion tactics, especially when well executed, can convince auditors to reduce their assessment of the severity of a control deficiency and more readily accept management's explanation associated with it.
- Field studies (e.g., Nelson et al (2002) show that auditors frequently waive what appear to be material adjustments to financial statements due to a variety of client induced pressures.

Whether auditors actions can deter fraud in addition to attempting to detect it when present has also been subject to recent academic scrutiny. Chin, Kelly and Salterio (2011) suggests that client managers observe how auditors are behaving. Those auditors that exhibit traits associated with enhanced professional skepticism (e.g. changing audit procedures from year to year, more vigorous and challenging inquiry of management) are better able to deter fraudulent employee actions before they occur than auditors who appear to value cozy client relationships.

### **Summary of this evidence**

The main purpose of writing this section was to inform the PCAOB that there is significant academic evidence published in peer reviewed accounting research journals (most of which appears in the most rigorous set of journals) that supports their concerns outlined on pp. 7-9. This evidence suggests that the inherent conflict of interest caused by the client firm hiring, firing and compensating the auditor does result in "the auditors involved fail(ing)ed to put the interest of investors before those of client management" as the PCAOB suspects (PCAOB Release No. 2011-006 p. 9). Furthermore, this evidence hints at the fact that direct client pressure (e.g. threats to put the audit out to tender) may be employed less often by management than persuasion tactics to get the auditor to see the accounting through the lens that management brings to the issue. I conjecture that direct pressure is more likely to result in the auditor's commitment to independence, objectivity and professional skepticism being activated resulting in "push back" to the client rather than being a distant construct that is part of the form checking mentality of independence reporting today. In other words, wise client management take advantage of the auditor's motivated reasoning to interpret evidence in light of how management wants to see the word yet still maintain their "illusion of objectivity." However, this explanation requires more research before it can be demonstrated.

Furthermore, the evidence I have cited is not exhaustive in this area. There are a large number of other studies that could be brought to bear to support the PCAOB's concerns about this inherent conflict of interest due to the current institutional arrangements.

## **Matter for the Board to consider**

I suggest that the Board's concerns are on the right track and that there needs to be continued focus on enhancing auditor independence, objectivity and professional skepticism. However, the focus on such issues may not lead to the solution contemplated "audit firm rotation." Indeed, I suspect that many commentators both academic and others will provide a large number of reasons why such a proposal would not meet any reasonable cost/benefit test. The key question is how do we embed in the audit firm with a greater attention to accuracy of client financial statements when regulation, litigation, independence requirements and ethics education all appear to have limited success in embedding this goal into the everyday activities of the audit firm? Indeed, if these had worked, there would be no reason for the PCAOB's release on auditor independence and audit rotation. Hence, I believe new approaches must be sought and that the guidance of history might be apt in this case.

I note that the Board in its Appendix A has taken note of the controversy about the need for an independent private sector audit (i.e. the current institutional arrangements) during Senate testimony regarding the original SEC Act of 1933. It is possible that other approaches considered at that time, including creating an independent audit unit that would randomly carry out in depth audits of companies as part of the Federal Trade Commission (or some other government authority) might be revisited. That is combine the best features of today's regime with the ability of an independent government institution to carry out in depth audits of clients perhaps when the audit firm audits of particular clients are questioned by the PCAOB. In other words, take advantage of the well-known aversion of US firm management to avoid government intervention into their businesses by making them the ones that insist on high quality audits. But would this work? The motivated reasoning literature that I have cited explores an alternative lens through which a reasoner might see the world, that is, with a motivation to be "accurate." As Kunda (1990) put it:

The work on accuracy-driven reasoning suggests that when people are motivated to be accurate, they expend more cognitive effort on issue-related reasoning, attend to relevant information more carefully, and process it more deeply, often using more complex rules.

P. 481

Conceptually, this would result in the auditors being given strong motives by their client's management to uphold the "accuracy" of financial statements to avoid government intervention into their business. Furthermore, this recommendation is consistent with my diagnosis of what is at the heart of the current audit malaise, the auditor taking the very natural course of seeing all, but the most extreme violations of GAAP, through the eyes of client management as a motivated reasoner. If management is demanding more "accurate" financial statements to keep the long arm of the government out of its business, then the auditor is more likely to have and take to heart a goal of enhanced financial reporting accuracy as the auditor's motives would be aligned with those who pay him – firm management

## **Aside on the audit failure rate question**

Numerous academic and professionals have cited studies that suggest the rate of audit failure in the USA is substantially less than 1%. These studies have generally examined SEC Enforcement Actions as well as lawsuits that can be located using various legal databases to conclude that the number of such occurrences is less than 1% of the number of audits carried out in the USA in a given year.<sup>1</sup> The most famous of these studies (Francis 2004), I suggest underestimates the rate of audit failures and overstates the number of public companies traded on US stock exchanges leading to the extensively quoted conclusion that “substantially less than 1% of all US audits fail.”

The PCAOB release states “the Board inspectors have reviewed portions of more than 2800 engagements of such firms and discovered and analyzed several hundred cases involving what they determine to be audit failures” (PCAOB 2006 p. 5). Just employing the Big 4 plus BDO and Grant Thornton to estimate the number of failures examined in the public reports of the PCAOB from 2004 to 2009 one finds about 321 cases.<sup>2</sup> Here with a rate of 53.5 documented audit failures a year we have direct evidence that contradicts Francis (2004) that there are 28-42 public company audit failures a year. For the audit failure rate documented by the PCAOB as being substantially less than 1% of all audits there would have to be 32,000 to 64,000 audits of public companies during that period in the USA. Furthermore, in these 32,000 to 64,000 audits would, except for the 321 the PCAOB has flagged, they would have to be unproblematic which we know is not correct given the inspection reports of the other audit firms registered with the PCAOB and the additional audits flagged in the one major firm audit report where parts of the non-public information are available.<sup>3</sup>

According to Grant Thornton there are about 5200 public companies traded on US stock exchanges (excluding companies on the “pink sheets” etc.) versus an all-time high in 1997 of 8800.<sup>4</sup> Given the period of time covered by the PCAOB reports is 2004 to 2009 or six years, that means in total in the USA there would be between 31,200 (using the current number of public companies) and 52,800 (using the all-time high) public company audits of firms traded on US exchanges in the period. In addition to showing that Francis (2004) obtains his 1% rate by using an overly generous number 10,000 public companies that overstates the denominator this calculation hence understates the audit failure rate; this calculation also demonstrates the degree of skepticism that a claim of an audit failure rate of less than 1% should be accorded.

The Table attached shows the computations referred to above.

While the PCAOB appropriately acknowledges that they choose audit clients files to examine based on risk, based on this analysis I believe the Board is understating the probative value of the evidence that Board inspectors have found to date. While a rate of 11% (321/2800) may be on the high side in estimating audit failure rates, the PCAOB has conclusive evidence that the much quoted “less than 1% audit failure rate” is a myth. Furthermore, if audits are generally planned with a between 1% and 5% risk of material misstatement occurring after audit (the popular audit risk model uses these two parameters while admitting that audit risk may be understated at this level), this should not be a surprise to anyone.<sup>5</sup> The key questions are: does this rate of failure

exceed the planned rates implicit in the audit risk model and are these planned rates of audit failure at a socially accepted level even assuming there are no biases and the audit is done when done appropriately?

<b>Testing the 1% rate of audit failure</b>							Total						
Firm\Year	2004	2005	2006	2007	2008	2009	2004-2009						
Deloitte	8	17	8	10	7	15	65						
E&Y	8	10	8	4	8	5	43						
KPMG	19	11	7	9	9	8	63						
PWC	12	9	6	6	6	9	48						
BDO	11	7	11	5	6	8	48						
Grant Thornton	15	12	8	5	9	5	54						
Total PCAOB audit failures documented for six audit firms							73	66	48	39	45	50	321

Estimated number of public companies traded on US Stock Exchanges including foreign listers/Total public companies available to be audited	6000	6000	5800	5600	5400	5200
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Rate per year assuming NO other audit failures occur in any other firm than these six audit firms	1.22%	1.10%	0.83%	0.70%	0.83%	0.96%
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Total audits that would need to take place without any additional failures at the cited 1% rate	32,100
Total audits of public companies for six year period listed on US stock exchanges including foreign listers	34,000
Total audits that would need to take place without any additional failures at the 0.50% rate that was actually computed in Francis (2004)	64,000

All numbers were derived from the PCAOB reports for each audit firm by simply counting the number of alphabetized cases in the appropriate release. It is likely that this understates the number of PCAOB identified audit failures as the recently released non-public parts of the Deloitte 2007 inspection report reveals other cases than those documented in the public part of the report (e.g., PCAOB Release No. 104-2008-070A p. 12)



## Research literature that may inform the Board's deliberations

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Fiolleau, K. K. Hoang, K. Jamal and S. Sunder. 2010. Engaging Auditors: Field Investigation of a Courtship. Working paper University of Alberta and Yale University. Available on SSRN. (Note this is the only unpublished paper cited).

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Salterio, S. & L. Koonce. The Persuasiveness of Audit Evidence: The Case of Accounting Policy Decisions. *Accounting, Organizations and Society*. (1997) 573-588.

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Wilks, T. J. 2002 Predecisional Distortion of Evidence as a Consequence of Real-Time Audit Review. *The Accounting Review* 77(1): 51-71.

Wolfe, Christopher J., Elaine G. Mauldin, and Michelle Chandler Diaz. 2009 "Concede Or Deny: Do Management Persuasion Tactics Affect Auditor Evaluation of Internal Control Deviations?" *The Accounting Review* 84(6): 2013-37.

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Steve has received the Queen's School of Business Research Excellence Award in 2011, the Canadian Academic Accounting Association's Haim Falk Award for Distinguished Contribution to Accounting Thought in 2008 and the American Accounting Association's Audit Section Notable Contribution to the Auditing Literature Award in 2009. He was honoured by the Institute of Chartered Accountants of Ontario with the title of Fellow of the Institute in 2006. He was an associate editor at *Contemporary Accounting Research* and is an editorial board member at *Auditing: A Journal of Practice and Theory*, *Behavioral Research in Accounting* and *The Accounting Review* among others. He has published nearly 50 articles in such journals as *Journal of Accounting Research*, *The Accounting Review*, *Contemporary Accounting Research*, *Accounting Organizations and Society*, *Auditing: A Journal of Practice and Theory* and other publication outlets both academic and practitioner oriented. He has written several book chapters and has a co-authored auditing and assurance textbook entitled *Auditing: Assurance and Risk* with Robert Knechel and Brian Ballou.

His research has received extensive external funding from government granting agencies (Social Sciences and Humanities Research Council) and industry (CICA, CAAA, CGA etc). In 2003 two of his professional articles (co-authored with Tony Atkinson) were recognized by the International Federation of Accountants' PAIB as Articles of Merit. His Ph.D. in business, specializing in accounting and cognitive psychology, is from the University of Michigan. He is a chartered accountant who is active in professional accounting organizations in Canada, acts as a consultant to large and mid-size public accounting firms on audit methodology and presents workshops to directors on governance and control.

## Endnotes

<sup>1</sup> Most citations of this 1% or less rate of audit failure can be traced back to a single article, J. Francis. 2004. What do we know about audit quality? *The British Accounting Review*. 36 (4): 345-368. Francis derives a rate of 0.28% if only lawsuits are employed as a proxy increasing this rate successively as he adds in SEC Enforcement Actions and bankruptcy data still leaving a rate of well less than 1%.

<sup>2</sup> Note that the years 2004 to 2009 are employed given that 2003 inspections did not follow the same procedures as later inspections and that 2010 inspection reports are not finalized for four of the six firms as of the date of this writing.

<sup>3</sup> The Deloitte inspection report for 2007 has had certain sections of Part II made public and there are several references in this part to potential audit failures beyond those documented in Part I of the report that is normally all that is made public (PCAOB Release No. 104-2008-070A for example see p. 12).

<sup>4</sup> <http://www.cfo.com/article.cfm/14563859> assessed on December 12, 2011, a number that includes foreign listers.

<sup>5</sup> See any audit textbook in the last decade.