

Written Statement of Erik F. Gerding

before the PCAOB Roundtable on Auditor Independence and Audit Firm Rotation

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My name is Erik F. Gerding, and I am a tenured associate professor of law at the University of Colorado Law School. My research and teaching focus on securities regulation, the regulation of financial institutions and markets, and corporate governance. In a forthcoming book entitled *BUBBLES, FINANCIAL REGULATION, AND LAW* (Routledge 2013), I examine how these different areas of law – including accounting rules – deteriorate during prolonged market booms and bubbles, just when they are needed the most.

Before entering the academy at the University of New Mexico School of Law in 2006, I practiced in the Washington, D.C. and New York offices of a large international law firm, where I worked on public and private securities offerings and securities regulatory and enforcement matters. The views expressed below are mine alone.

The Client-Pays Model Fundamentally Skews Incentives

After almost four decades, mandatory audit rotation continues to reappear on the federal securities regulatory agenda for a simple reason; the issuer-pays model for audit services creates powerfully skewed incentives for audit firms to compromise their independence, objectivity, and professional skepticism.¹ Reforms, particularly those of the Sarbanes-Oxley Act, have dampened these incentives, but not fundamentally.² Recent cases and studies indicate that auditors continue to compromise their independence, objectivity, or professional skepticism.³ Auditors too often acquiesce to the judgment of their source of revenue – the clients whose financial statements they audit.

This pressure can outweigh the risk of reputational loss and even legal sanctions for auditors who acquiesce.⁴ When issuers and less scrupulous actors at issuers possess greater leverage over audit firms and their personnel, this pressure intensifies and reputational damage and legal liability carry less weight.⁵ When a particular issuer represents a substantial, steady,

¹ Sean M. O'Connor, *Be Careful What You Wish for: How Accountants and Congress Created the Problem of Auditor Independence*, 45 B.C.L. REV. 741 (2004).

² See Sean M. O'Connor, *Strengthening Auditor Independence: Reestablishing Audits as Control and Premium Signaling Mechanisms*, 81 WASH. L. REV. 525, 571-79 (2006).

³ E.g., In the Matter of Ernst & Young, L.L.P. et al., PCAOB Rel. No. 105-2012-001 (Feb. 8, 2012).

⁴ Brian W. Mayhew et al., *The Effect of Accounting Uncertainty and Auditor Reputation on Auditor Objectivity*, AUDITING: J. PRAC. & THEORY, Sept. 2001 (providing experimental evidence that reputational losses do not deter auditors from compromising their objectivity).

⁵ For an economic analysis of the incentives of auditors and how these incentives were skewed during the Enron era, see John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid"*, 57 BUS. LAW. 1403

and longstanding revenue stream for an audit firm, the leverage of the issuer over individual audit personnel increases even more. At the same time, the deterrent effect of reputational loss for acquiescent audit firms has been blunted by consolidation in the accounting industry. If one of the Big Four audit firms suffers reputational damage for acquiescing to improper accounting, there are only three other alternatives. This may be too little competition for reputational effects to deter auditor acquiescence,⁶ but sufficient competition for non-acquiescent audit firms to fear a loss of business.⁷ Indeed, scholars have argued that the “commodification” of audit services has put considerable pressure on accounting firms to compromise their independence in audits and to seek additional sources of revenues from issuers.⁸

Economic incentives are not the only dynamics that work against auditor independence and professional skepticism. A potent cocktail of social pressure and psychological biases can also subvert independence, even without an auditor’s conscious awareness.⁹ The power of these social and psychological dynamics may increase when clients enjoy long histories with an audit firm and command a significant source of its revenue. Disagreements over accounting treatment are routine in the scope of an audit. The inescapable uncertainty surrounding accounting treatment creates powerful conditions for auditors to compromise their objectivity to satisfy issuers.¹⁰ Imagine an auditor confronted with what she (or he) perceives as improper accounting by an issuer that her (or his) firm has represented for longer than she (or he) has been employed or even alive. The pressure to conform can be intense.

The skewed incentives created by the issuer-pays model are by no means unique to the audit function. Indeed, scholars have argued that other “gatekeepers”¹¹ – that is

(2002); John C. Coffee, Jr., *What Caused Enron? – a Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269 (2004).

⁶ See, e.g., Sean M. O’Connor, *The Inevitability of Enron and the Impossibility of “Auditor Independence” Under the Current Audit System* 64-67 (unpublished manuscript) (Mar. 1, 2002), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=303181; Coffee, *Understanding Enron*, *supra* note 5, at 1413-15; Jonathan R. Macey & Hillary Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 VILL. L. REV. 1167, 1176-82 (2003).

⁷ Price competition for audit services seems to remain robust despite accounting industry consolidation. See, e.g., GENERAL ACCOUNTING OFFICE, PUBLIC ACCOUNTING FIRMS: MANDATED STUDY ON CONSOLIDATION AND COMPETITION (July 2003) available at <http://www.gao.gov/products/GAO-03-864>.

⁸ See Macey & Sale, *supra* note 6, O’Connor, *supra* note 2, at 542-559.

⁹ See, e.g., Robert A. Prentice, *The Case of the Irrational Auditor: a Behavioral Insight into Securities Fraud Litigation*, 95 NW. U. L. REV. 133 (2000); Don A. Moore et al., *Conflicts of Interest and the Case of Auditor Independence: Moral Seduction and Strategic Issue Cycling*, 31 ACAD. MGMT. REV. 10 (2006).

¹⁰ Mayhew et al., *supra* note 4.

¹¹ In two decades of research, scholars have employed two definitions of gatekeepers. The first definition focuses on the *certification* role of gatekeepers. This definition views gatekeepers as “reputational intermediaries who provide verification and certification services to investors.” Coffee, *Understanding Enron*, *supra* note 5, at 1405. Under the second definition, gatekeepers *restrict access* to the market by securities issuers who do not conform to legal (and market) standards, and the gatekeeper stakes its reputation on those firms who are granted access. See Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J. L. ECON. & ORG. 53, 53 (1986) (defining gatekeepers as “private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers”).

reputational intermediaries who certify financial information regarding a securities issuer – have failed because of the incentives created by an issuer-pays model. The failure of credit rating agencies to give an adequate early warning of the imminent financial risk during the Panic of 2007-2008 replayed their earlier failure during the Enron era.¹² The incentives of credit rating agencies and audit firms are further skewed by the fact that government regulations have given both groups of firms guaranteed income and a virtual oligopoly position via what one scholar calls “regulatory licenses.”¹³

The pressures on auditors to compromise their independence resist easy fixes. Moreover, they can become particularly virulent and dangerous during critical market periods. The Public Company Accounting Oversight Board (the “Board”) has established a track record of inspections that have uncovered lapses and abuses of auditor independence. Nevertheless, financial history should dishearten the public’s confidence in the ability of ordinary enforcement efforts to counter successfully financial manipulation during prolonged market booms. These boom periods multiply the gains to accounting misconduct, increase the pressure on auditors and other gatekeepers to acquiesce, delay the moment in which the market or regulators discover misconduct, overwhelm the resources of regulators, and exacerbate the behavioral biases of individuals at issuers, audit firms, and even regulatory agencies. All of this works to undermine auditor gatekeeping as well as the efforts of those regulators who watch the watchers.¹⁴ In my book, I document the diminishing effects of market and legal checks during market booms and the accompanying epidemics of financial fraud and accounting misconduct from the English railway manias of the 19th Century to the Roaring 1920s through to the Enron era and the current global financial crisis.¹⁵

We should thus be concerned that the Board’s current inspection and enforcement tools and approach work to counter adequately the pressures against auditor independence in “ordinary” market periods, let alone in more dangerous boom times.

Counteracting Perverse Incentives Requires Deep Reforms

The deep and lasting incentives created by the issuer-pays model for audit firms cannot be corrected by piecemeal reforms. The simplest and most powerful reform would be to

¹² E.g., Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619 (1999) (providing early critique of perverse rating agency incentives created by “regulatory license” granted to agencies by government); Lawrence J. White, *The Credit Rating Agencies*, 24 J. ECON. PERSP. 211, 218-221 (2010) (criticizing rating agency performance during Enron and subprime crises because of “issuer pays” model).

¹³ Partnoy, *supra* note 12 (describing regulatory licenses enjoyed by credit rating agencies); O’Connor, *supra* note 1 (describing how federal securities laws created guaranteed revenue stream for accounting firms by mandating “independent” audits of public companies).

¹⁴ ERIK F. GERDING BUBBLES, FINANCIAL REGULATION, AND LAW (Routledge Press forthcoming 2013). Erik F. Gerding, *The Next Epidemic: Bubbles and the Growth and Decay of Securities Regulation*, 38 CONN. L. REV. 393 (2006).

¹⁵ GERDING BUBBLES, FINANCIAL REGULATION, AND LAW, *supra* note 14, Chapters 2, 3, and 4.

give an issuer's shareholders direct control of the selection of auditors.¹⁶ This reform, however, would require action by the Securities and Exchange Commission and likely additional legislation.

Relying solely on audit committees and audit committee reforms to fix the incentive problems created by the issuer-pays model would be unwise. These reforms assume that the audit committee has the proper incentives to protect shareholder interests and counterbalance management as the committee chooses and supervises auditors.¹⁷ Even properly motivated audit committees may lack the capability to ensure the independence of auditors. Ultimately, the audit committee cannot supervise day-to-day accounting at the issuer, but must rely on the auditors to provide it with crucial information. Auditors' daily contact will remain with the management and employees of the issuer. Auditors will be subject to pressures, subtle and not-so-subtle, at every level of management to shape the information and judgments shared with the audit committee. Moreover, psychological biases and social pressures may mean that auditors are unaware of how they have been influenced and their independence, objectivity, and skepticism potentially compromised.¹⁸

Increased training and internal governance reforms within audit firms may be able to "debias" audit firm personnel to a degree. However, there is little evidence to suggest that education and internal institutional checks alone can correct severe cognitive biases, let alone counteract the deep and pervasive incentives for auditors created by the issuer-pays model.

Notes on Evaluating the Empirical Evidence

Mandatory audit rotation, on the other hand, would likely have significant effects on bolstering auditor independence by reducing the expected benefit to auditors of acquiescing to improper accounting. This rule would also make auditors more cautious, as they would know that another firm would soon review their work. In considering the merits of mandatory audit rotation, the Board has been considering a large volume of empirical research on the relationship between length of an auditor's tenure at the issuer and audit quality. Analyzing this evidence requires great care for several reasons. *First*, many of these studies rely on cases in which the issuer voluntarily switched auditors. This means that studies that show lower measures of audit quality in the early years of an auditor's tenure may be subject to significant sample biases. For example, issuers who choose to switch auditors may be more likely to have aggressive accounting. More perniciously, an issuer might choose to switch an auditor in the hopes that a new firm will be unable to uncover questionable accounting. However, these studies still

¹⁶ O'Connor, *supra* note 2, at 586-90. See also Brian W. Mayhew & Joel E. Pike, *Does Investor Selection of Auditors Enhance Auditor Independence?*, 79 ACCT'G REV. 797 (2004) (providing experimental evidence that auditors chosen by shareholders decreases independence violations).

¹⁷ A number of legal scholars have sharply questioned this assumption. O'Connor, *supra* note 2, at 578-79.

¹⁸ *Supra* note 9, and accompanying notes.

underscore that the Board must consider how newly chosen audit firms face a potentially steep learning curve in beginning their work at an issuer.

Second, it is vital to unpack how studies are measuring audit quality, which is extremely hard to measure. Many studies focus on the problem of earnings management and focus on the size of discretionary accruals as a proxy for audit quality (with large accruals indicating poorer quality).¹⁹ A more nuanced research approach is taken Professors Davis, Soo, and Trompeter in a 2009 study that examines when discretionary accruals allowed a firm to meet an earnings forecast that otherwise would have been missed.²⁰ One could draw an analogy to criminal forensics in describing this study. The authors look not only at whether a weapon was present, but whether it was used when there was motive and opportunity. The study found evidence of increased use of accruals in this scenario as auditor tenure increased.²¹ The effect, however, became pronounced only after the 14th year of an auditor's tenure. The authors speculate "prior studies' inability to detect a long tenure effect [on deteriorating audit quality] may be due to their specification of what constitutes long tenure."²² The study found these results only in a pre-Sarbanes Oxley period, but not after that statute was signed into law. The authors ask whether any effect of the Sarbanes Oxley Act is "permanent or transitory."²³

Design Features to Alleviate Concerns with Auditor Rotation

The Board could design a mandatory auditor rotation rule to include certain features that would mitigate some of the risks commentators have identified with the rule. The risk of information loss as an issuer rotates from one audit firm to another could be mitigated by requirements that the departing firm prepare handover memos for the new firm identifying critical accounting issues identified on their watch. The Board should consider creating proper incentives – such as increases in (or safe harbors from) liability for Board sanctions – to ensure that handover memos contain sufficient information.

Nuanced Approaches: Start with Case-by-Case Audit Rotation

Even with these design features, a mandatory audit rotation requirement will be open to legal challenge. One previous comment to the Board fired a warning shot across the bow of any generally applied mandatory auditor rotation rule. The commentator argued that a broadly applied rule would be susceptible to challenge in federal court for failure to account for

¹⁹ E.g., E. Johnson et al., *Audit-Firm Tenure and the Quality of Financial Reports*, 19 CONTEMP. ACCT'G RES. 637 (2002); James N. Myers et al., *Exploring the Term of the Auditor-Client Relationship and the Quality of Earnings: A Case for Mandatory Auditor Rotation?*, 78 ACCT'G REV. 779 (2003).

²⁰ Larry R. Davis, et al., *Audit Tenure and the Ability to Meet or Beat Earnings Forecasts*, 26 CONTEMP. ACCT'G RES. 517 (2009).

²¹ *Id.* at 540-41.

²² *Id.* at 519.

²³ *Id.* at 540.

economic costs and benefits.²⁴ While I believe that a mandatory audit firm rotation rule could be ultimately be justified by economic benefits outweighing costs, the U.S. Court of Appeals for the D.C. Circuit has demonstrated a recent propensity for second-guessing and overturning financial regulations.²⁵ Cramped interpretations of cost-benefit analysis can too easily favor the status quo by allowing industry-driven estimates of the economic costs of complying new rules to outweigh the benefits of prophylactic rules. It is hard to see the scandals and crises that regulations prevent.

Even so, to lower the risk of having a broadly applicable rule challenged in court, the Board should consider first imposing audit rotation on a case-by-case basis rather than a broadly applicable rule. The Board should have in its arsenal the ability to require a public issuer to retain a new auditor upon a finding that an audit firm compromised its independence, objectivity, and professional skepticism in auditing that company. The Board should then have the further ability to subject that issuer to mandatory audit firm rotation. This case-by-case remedy would overcome objections to the empirical basis for a broadly applicable mandatory audit firm rotation. Congress has already specified the procedures for Board inspections and disciplinary hearings.²⁶ Requiring audit firm rotation would give the Board a powerful and explicit tool in remedying abuses by auditors.

Taking Auditor Reputation Seriously Part I: Disclosing Findings of Board Inspections, Investigations and Disciplinary Proceedings

The Board should also take the disciplining effects of auditor reputation, however imperfect they may currently be, seriously and take steps to publicize better Board findings of the results of inspection, investigation, and disciplinary hearings. Although Congress restricted the ability of the Board to disclose publicly inspection reports and disciplinary proceedings, it did not prohibit disclosure outright.²⁷ The Board may disclose publicly “portions of the inspection report that deal with criticisms of or potential defects in the quality control systems of the firm under inspection” if the firm does not address those criticisms, “to the satisfaction of the Board” within “12 months after the date of the inspection report.”²⁸ The Board may also publicly disclose sanctions imposed after disciplinary hearings unless a stay is in effect.²⁹ The Board should actively use these powers to make real the reputational effects of improper auditor behavior. Reputational markets and the deterrent of reputational loss will continue to have too weak an effect on auditor actions to the extent that the findings of the Board with respect to particular audit firms and their personnel remain shrouded in secrecy.

²⁴ Harvey L. Pitt, Statement before the Public Accounting Oversight Board Concerning Auditor Independence and Audit Firm Rotation, Washington, D.C. 17-21 (March 21, 2012).

²⁵ *E.g.*, *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011) (vacating SEC proxy access rule);

²⁶ 15 U.S.C. §§ 7214, 7215.

²⁷ 15 U.S.C §§ 7214(g);

²⁸ 15 U.S.C §§ 7214(g)(2).

²⁹ 15 U.S.C. § 7215(d)(1)(C).

Taking Auditor Reputation Seriously Part II: Requiring Additional Disclosure in Auditor Opinions

This leads to the question of how the Board could better publicize its sanctions. The Board should also use its statutory authority to improve the quality of information contained in auditor opinion letters. Currently, the auditor's opinion letter contains little informational content beyond whether the opinion is "clean" or "qualified." The opinion letter could be overhauled to give investors and capital markets a richer picture of the scope and quality of an auditor's review.³⁰ Requiring certain additional information in the auditor's letter could vastly improve the ability of investors to judge the quality of the audit and the independence of the auditor. This information would include:

- a. **Disclosing the identity of the audit partners and staff:** The current form of letter is signed by the audit firm and not by individual partner responsible for the audit. Disclosing the identities of the individuals who worked on the audit would help investors assess their reputation and reliability. If a lack of competition among the Big Four impedes reputational markets, then the Board should enable investors to look to the reputations of responsible individuals. Moreover, audit firms face a persistent agency cost when their partners and employees care more about their personal costs and benefits than the reputation of the firm. Individuals may be willing to deplete the reputation of their firms for personal gain.

Disclosing the names of audit personnel would also have a secondary effect of providing a sobering reminder to these individuals of the need for independence, objectivity, and professional skepticism. More granular disclosure on the audit firm personnel could include:

- i. *Whether any of these individuals worked on financial statements that were subsequently restated;* and
- ii. *Whether any of these individuals were sanctioned by the Board, including by censure:* this would ensure that investors could easily learn of any Board sanctions for compromises of auditor independence.

³⁰ James D. Cox, *Strengthening Financial Reporting: an Essay on Expanding The Auditor's Opinion Letter*, __ GEO. WASH. L. REV. __ (forthcoming 2013). Professor Cox recommends enhancing the auditor opinion letter to include:

- ¶ A statement by the audit firm on whether its discussion with an issuer's Audit Committee reflected different "critical accounting assumptions, estimates and judgments" compared to those disclosed in Management Discussion and Analysis;
- ¶ Disclosure on certain metrics that would indicate the issuer is in financial distress. *Id.*

- b. Disclosing data on the audit firm’s relationship to the issuer:** the auditor’s opinion should also include the following information on the auditor’s relationship with the issuer relevant to the quality of the audit and the auditor’s independence:
- i. *The total compensation*** of the audit firm from the issuer and a breakdown of audit and non-audit revenue from the issuer for the last year, five years, and (to the extent practical) over the life of the auditor’s tenure with the issuer; and
 - ii. *The employees of the issuer who used to work at the audit firm:*** This would give investors a sense of whether there has been a “revolving door” between audit firm and issuer.
- c. Disclosure on the past quality of the audit firm’s work:** Investors would also benefit from the following information on the past performance of the audit firm:
- i. *Data on recent restatements of financial statements originally audited by the firm;***
 - ii. *Details of any sanctions imposed by the Board on the firm.***

Although the Board can and does disclose much (but not all) of this information itself (such as sanctions publicized in Board releases), there are a number of advantages to having this information in an auditor’s opinion letter, including providing an issuer’s investors with easier and more immediate access to information on the quality of the issuer’s auditor.

Countercyclical Enforcement

Finally, regardless of how the Board proceeds with mandatory audit rotation, I would strongly counsel the Board to take steps to make its own inspection and enforcement efforts “countercyclical.” As mentioned above, my research indicates that financial market booms can cause the effectiveness of enforcement efforts by financial regulators to deteriorate radically.³¹ At the same time, booms can undermine the incentives and norms of accountants, issuers, and other market participants to comply with accounting and other financial rules.³² Accordingly, the Board should consider measures to increase – *even automatically* – inspection and enforcement measures during financial booms to ensure that enforcement efforts are not diluted when they are needed most – when markets boom and the risk of fraud spikes.

³¹ *Supra* note 14-15 and accompanying text.

³² GERDING BUBBLES, FINANCIAL REGULATION, AND LAW, *supra* note 14, Chapter 4.