Statement of

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Chairman Doty, members of the Board, and staff:

Thank you for the opportunity to comment on the PCAOB's Concept Release on Auditor Independence and Audit Firm Rotation. It is a great privilege to speak with you today.

Although concerns about conflicts of interest in auditing and indeed in other professions seem commonplace today, the term – and the concept itself – has a relatively short history, first appearing in law dictionaries and codes of ethics beginning in the 1970's. This relatively recent awareness of the problems caused by conflicts of interest has likely been driven by the types of advisory relationships inherent in an increasingly complex business environment. In short, we have become much more dependent on the judgment of others, and much less able to evaluate those judgments [4].

This trend is perhaps nowhere more evident than in accounting where financial accounting and reporting standards increasingly require an extraordinary level of judgment by managers in preparing the financial statements and by auditors in assessing whether those financial statements present fairly the company's financial condition and performance. In this environment, it is not surprising that concerns arise about whether we have the best model to allow auditors to maintain their objectivity and effectively exercise professional skepticism.

What can be done about conflicts of interest? Three categories of responses are typically proposed. The first is to fundamentally redefine the underlying relationship to remove the conflict of interest. So, for example, a judge with financial or other conflicts in a case before her court may recuse herself in favor of another judge with no such conflicts. Short of a radical overhaul of the existing auditor-client relationship, including, but not limited to, the client-payer model, we must accept that it is not possible to completely eliminate the auditor's inherent conflict of interest.

A second response that is frequently proposed is to disclose the nature of the conflict. In this vein, some have suggested that the company disclose the length of the audit relationship and other clarifying information in the proxy statement or 10-K. The public, thus informed, should be able to assess the potential for the auditor's independence to be compromised and adjust their reliance on the associated audited financial statements accordingly. However, research casts doubt on the effectiveness of conflict of interest disclosures. The simple fact is that people do not discount the judgment of advisors with misaligned incentives as much as they should, even when the conflict of interest is disclosed [3,6].

This leaves the third type of response which is to manage the conflict; in essence, to partially realign the auditor's interests, albeit not enough to eliminate the conflict of interest but enough to make it likely that the benefits will outweigh the costs. Mandatory audit firm rotation is one such response intended to realign the interests of auditors more closely with those of the investing public. It is important to recognize, however, that mandatory rotation may not be enough to significantly improve independence if auditors continue to face the threat of dismissal at the discretion of the client.

As a result, there are really four possible regimes to consider: (i) neither mandatory rotation nor mandatory retention, (ii) mandatory rotation only, (iii) mandatory retention only, or (iv) mandatory rotation and mandatory retention. Experimental evidence comparing these four regimes shows that auditors are significantly more likely to issue a report biased in favor of the client in the regime with neither mandatory rotation nor retention – the model currently employed in practice – relative to each of the other three regimes [5]. Auditors are most conservative in the regime with both mandatory rotation and retention. Overall, these findings suggest that mandatory rotation can increase independence either as a stand-alone rule or in conjunction with mandatory retention.

Several other studies using experimental techniques concur on the efficacy of mandatory audit firm rotation. This conclusion stands in contrast to a body of research using archival data to document a positive relation between audit firm tenure and audit quality. However, as other commentators have already noted, it is particularly difficult to draw inferences about the effects of mandatory audit firm rotation from those studies because of data limitations and other research design issues.

A compromise position to mandatory audit firm rotation is mandatory audit tendering. There are few examples of this model in practice and it has not been studied widely by accounting researchers. I was able to identify only two related studies based on public sector experience with mandatory tendering in Australia where local councils call open tenders for audit services every six years for the following guaranteed six-year tenure period [1,2]. The evidence suggests that audit fees decreased following the introduction of mandatory tendering, but that fees were secondary to audit quality considerations in the decision to retain the incumbent or appoint a successor. If the incumbent participates in the tender, however, there is a high probability of retention. Although these findings are difficult to generalize and should be interpreted with caution, there is nothing to suggest that mandatory tendering would impair audit quality or auditor independence.

Of these two options – mandatory rotation versus mandatory tendering – I believe that rotation offers the greatest potential to fundamentally realign auditors' interests to the benefit of the investing public. Tendering is more likely to result in a form over substance solution with little effective change in the auditor-client relationship beyond a periodic justification for retention.

In closing, I will comment on two additional issues inherent in managing conflicts of interest. The first is the cost-benefit trade-off of the proposed response. If this was easy to quantify, then we would not be here. Compounding the problem is that the costs of mandatory audit firm rotation are concentrated while the benefits are diffuse. Audits are a public good. However, the benefits to investors of high quality financial statements are substantial. Continuing with the status quo at a time when more and increasingly complex judgments are being demanded of auditors is likely to only increase the probability of audit failures and the resulting losses suffered by investors.

Second, managing a conflict of interest can involve structural changes in the advisory relationship – such as mandatory audit firm rotation – but inevitably also requires ongoing and independent oversight to ensure that the auditor's conflict of interest does not interfere with the proper exercise of judgment. The first line of defense in this situation is a strong and capable audit committee. By all accounts, audit committees have improved in the post-Sox era but more could and should be done to strengthen their role. Research shows that all too often management still plays a dominant role in overseeing the audit function. Moreover, criteria for qualifying as a financial expert are too nebulous and do not ensure the level of knowledge and experience necessary to provide adequate oversight. The audit committee should include members that not only have demonstrable expertise and experience in financial accounting and reporting but the entire committee should be required to complete a minimum number of accounting and auditing continuing education hours each year.

In conclusion, I support the PCAOB's efforts to consider mandatory audit firm rotation and other meaningful reforms that will enhance auditor independence and objectivity. Thank you again for allowing me to participate in this timely and important discussion.

Selected sources:

[1] Boon, K., S. Crowe, J. McKinnon, and P. Ross. 2005. Compulsory audit tendering and audit fees: Evidence from Australian local government. *International Journal of Auditing* 9: 221-241.

[2] Butcher, K., G. Harrison, J. McKinnon, and P. Ross. 2011. Auditor appointment in compulsory audit tendering. *Accounting Research Journal* 24: 104-109.

[3] Cain, D., G. Loewenstein, and D. Moore. 2005. The dirt on coming clean: Perverse effects of disclosing conflicts of interest. *Journal of Legal Studies* 34: 1–25.

[4] Davis, M. and A. Stark (editors). 2001. *Conflict of Interest in the Professions*. Oxford University Press, New York.

[5] Dopuch, N., R. King, and R. Schwartz. 2001. An experimental investigation of retention and rotation requirements. *Journal of Accounting Research* 39 (June): 93-117.

[6] Malmendier, U., and D. Shanthikumar. 2007. Are small investors naive about incentives? *Journal of Financial Economics* 85 (2): 457–89.