Mark W. Nelson statement for 10/18/12 PCAOB public meeting on auditor independence and audit firm rotation:

It is an honor to speak with you today. My name is Mark Nelson and I am the Eleanora and George Landew Professor of Accounting at the S.C. Johnson Graduate School of Management at Cornell University. For over 20 years, much of my research has examined issues related to audit judgment and auditors' professional skepticism (PS). One recent project synthesizes over 250 research studies and develops a model of the determinants of PS. I will draw on that research to make my remarks today. Consistent with the PCAOB's August 16, 2011 Concept Release, I will make my remarks within the context of the current client-payer audit model, and focus on the effects of rotating audit firms on the PS of auditors within those firms.

I view an individual auditor's PS as influenced by three factors:

1. Traits, or innate person-specific characteristics that determine personality and tendency towards skepticism.
2. Knowledge, gleaned from education, training and experience.
3. Incentives, defined broadly to include such considerations as expected future fees from a valuable client, potential costs associated with negative inspections and audit failures, and the desire by auditors in the field to be evaluated highly and meet their time budgets.

These three factors combine with features of the auditing context and various auditor judgment processes to determine the extent to which individual auditors' judgments and actions reflect PS. When I consider mandatory firm rotation from the perspective of this model, a number of points stand out.

First, I'll ignore traits, assuming that firm rotation results in assignment of auditors who possess roughly the same levels of innate PS. I'll focus on knowledge and incentives.

Auditor Knowledge. We already have mandatory rotation of individual audit partners, but mandatory rotation of audit firms could affect the knowledge applied on an audit in at least two ways:

1. Client-specific knowledge: An audit firm develops a detailed understanding of their client, and that knowledge is updated over time through repeated interactions. A cost of mandatory rotation is that it nullifies client-specific knowledge and requires auditors at a new firm to replicate it, putting auditors at the new firm at an initial disadvantage.
2. "A fresh look": Audit firms may not update their knowledge to the extent that they should. A benefit of mandatory rotation is a forced reconsideration that provides a fresh look beyond what would occur by only rotating personnel within the same firm. One approach to reducing the loss of client-specific knowledge associated with mandatory rotation could be to enhance predecessor/successor auditor communications. However, that enhanced communication likely would reduce the extent to which the successor auditor provides a fresh look.

Auditor Incentives. Much research indicates that incentives can affect auditors' judgments consciously as well as unconsciously. So the question isn't *whether* incentives will influence auditor judgments, but rather how a particular institutional change like mandatory firm rotation will affect the balance of the incentives of the auditors that do the work. I think there are four changes in incentives to consider.

1. Reduced economic bonding: One benefit of mandatory firm rotation is that it reduces the stream of future payments that the audit firm risks when an auditor disagrees with their client. That change should reduce the auditor's incentive to please their client. I think this benefit would occur primarily in the couple of years immediately preceding mandatory rotation, as prior to that point the future fee stream at risk still would be very large. Instituting a rule that prevents the client from dismissing their auditor would extend these benefits over the life of the audit engagement, but might unduly restrict a client from changing auditors.
2. Second-guessing by the successor auditor: Another potential benefit of mandatory firm rotation is that it exposes the auditor to second-guessing by a successor auditor. If that second guessing adds to the exposure that auditors currently face from PCAOB inspections, incentives for audit quality should be enhanced. Once again, I think this benefit would occur primarily in the couple of years immediately preceding mandatory rotation.
3. Shifting problems to the successor auditor: In contrast, a potential cost of mandatory firm rotation is that auditors may perceive little incentive to deal with smaller but escalating problems just prior to rotation. Shifting those problems to the successor auditor might be particularly attractive if the current auditor depends on recommendations from their current clients as they seek new clients.
4. Pressures to enhance audit efficiency: Another cost of mandatory rotation arises because auditors may have to price their services lower in order to compete effectively as they aggressively pursue more clients. Audit firms may respond to lower pricing by decreasing the resources they devote to audits and performing engagements under greater time pressure, which could compromise PS.

Overall, the model and extant research highlight multiple ways that mandatory rotation could increase or decrease auditors' PS by affecting auditors' knowledge and incentives. Under a very short rotation period, I think it is likely that the costs associated with obtaining and setting-up new clients would dominate the benefits. Under a longer rotation period, the costs are spread over more years, but the benefits of rotation are reduced. On balance I don't see a persuasive case for mandatory audit firm rotation increasing auditors' PS.

It also might be useful to use this framework to consider mandatory retendering, whereby companies don't have to rotate auditors, but instead must put the audit up for bid. I think that approach is problematic. An advantage of retendering is that clients could choose to retain auditors if they believed the auditor had a particular knowledge advantage. However, as the retendering date neared, I think auditors would be particularly concerned about pleasing their client to avoid losing the engagement, while still being exposed to high fee pressure due to competitive bidding. Also, second guessing by a successor auditor may be a low-probability event, rather than a sure thing, reducing that benefit. On balance, I don't see mandatory retendering as likely to improve PS, and it might be counterproductive.

I'd like to close by encouraging the PCAOB to also consider other changes in the current audit setting besides mandatory firm rotation that could be used to address some of the concerns about PS indicated in the PCAOB's Concept Release. As an example, the Concept Release indicates concern that some auditors do not sufficiently challenge management's assumptions with respect to critical accounting estimates. I am involved in a research project that provides evidence that at least some of that problem might be caused by the way audit standards and procedures are written, rather than by a lack of mandatory firm rotation.

In our study, experienced audit managers participate in a simulated audit planning task for a level-3 fair value estimate. We vary between auditors whether audit procedures are framed positively, as is done in current standards and practice, or negatively. For example, a procedure described with a positive frame is "determine whether client assumptions are reasonable," while the same procedure described with a negative frame is "determine whether client assumptions are *not* reasonable." Our results indicate that auditors given a positive frame plan significantly fewer hours than do auditors given a negative frame, particularly with respect to procedures that the auditors view as less verifiable, like those that assess the reasonableness of assumptions. An implication is that other changes in audit standards and practice besides mandatory firm rotation potentially could improve PS with respect to some of the issues that are indicated in the Concept Release.

In our study we also vary whether the audit managers are under pressure to design a particularly efficient audit. Similar to prior research, our results indicate that auditors plan significantly fewer hours when under high efficiency pressure. These results suggest that increasing efficiency pressure, as might occur with more frequent competitive bidding that could accompany mandatory firm rotation, might reduce planned audit effort and thus potentially reduce PS.

I hope you find these remarks of use as you consider this important topic. I'm happy to provide further information. Thank you.

Related Research:

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