Comments to PCAOB Rulemaking Docket Matter No. 37 "CONCEPT RELEASE ON AUDITOR INDEPENDENCE AND AUDIT FIRM ROTATION"

Even if the academic literature has studied the effects of the introduction of the mandatory audit firm rotation rule on audit quality over the last decades, the actual benefits of this regulatory action are still uncertain.

On one hand, mandatory rotation is believed to enhance audit independence, and therefore increase audit quality, by imposing a break on potentially dangerous strict relationships between the auditor and the clients' management. This assumption is consistent with the idea that long audit tenures lead to a decrease of audit quality.

On the other hand, however, imposing auditor rotations necessarily brings in information asymmetry costs, which would cause lower audit quality in the first years of the engagement.

Even from an empirical point of view, the analysis of the mandatory rotation rule introduction has not lead to a clear picture yet.

This is mainly given by the fact that, as the rule at the present time is actually enforced in relatively few countries[1], most of the academic papers tried to infer the effects of the rule indirectly, by analyzing the relationship between auditor tenure and attributes of reported numbers, thus empirically testing the popular above mentioned view that long-term relationships between external auditors and their clients might result in aggressive accounting. Contrary to this assumption, the literature has provided evidence of a positive association between audit tenure and the quality of financial reporting (Myers, Myers and Omer, 2003; Johnson, Khurana and Reynolds, 2002), the likelihood of issuing going concern opinions (Jackson, Moldrich and Roebuck, 2008) and a negative association with audit reporting

[1] The mandatory audit firm rotation is enforced, apart from Italy, in Brazil, South Korea, Singapore and India (Cameran et al., 2005). At the end of November 2011, European Commission issued a proposal for enforcing such a rule in EU.

failures (Geiger and Raghunandan, 2002), and fraudulent reporting (Carcello and Nagy, 2004).

Still focusing on voluntary settings, other papers analyzed the effects of (voluntary) auditor switches on audit quality, in order to determine whether the greater degree of independence, which should characterize the incoming auditor, might compensate for the higher degree of information asymmetry between the auditor and client.

The main results of this stream of literature suggest that a voluntary auditor change is usually motivated by either the desire of managers to shop for "suitable" opinions (Lennox, 2000) or auditors resigning owing to high litigation risk (DeFond and Subramanyam, 1998).

This evidence does not suggest positive effects on audit quality after a (voluntary) auditor switch. On the other hand, Nagy (2005) took advantage of the Arthur-Andersen exit from the audit market to study companies that switched auditors after the failure of the audit firm and finds a significant decrease in discretionary accruals (and therefore increase in audit quality) for ex-Andersen clients, but only for the smallest companies of the sample.

Taking these findings together, it is not sure whether audit rotations may improve audit quality.

However, it is also difficult to conclude from these findings that mandatory audit firm rotations will play a negative role. This is because the economic forces present in a regime of mandatory rotations are likely to be different than in long-term relationships.

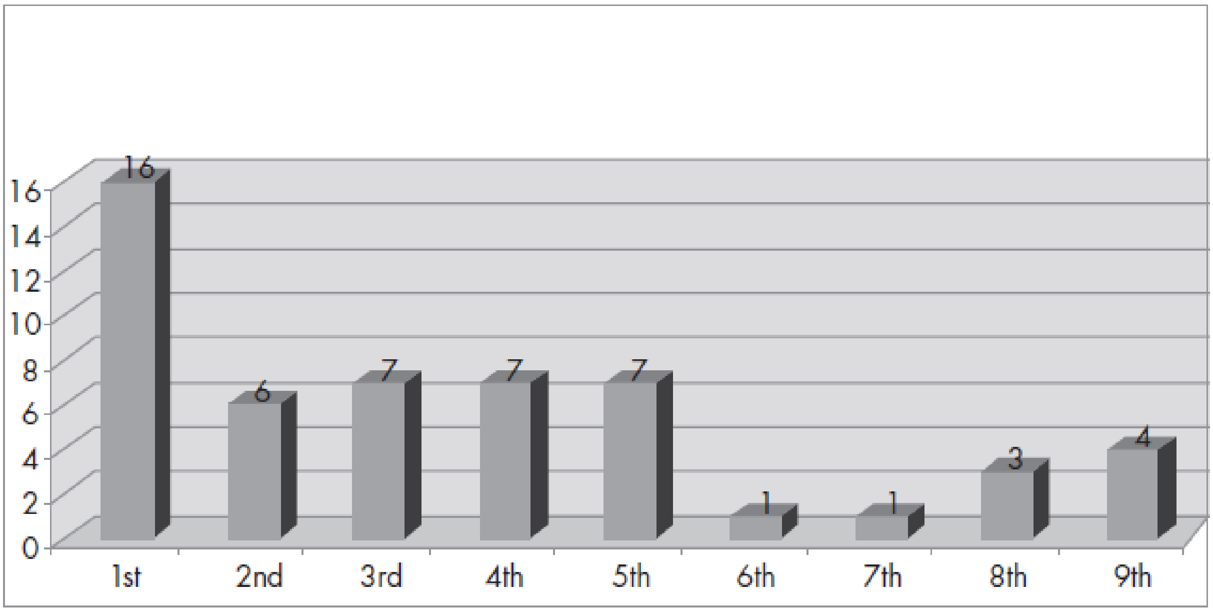
First of all, audit tenure is typically shorter (on average) in a mandatory rotation setting compared to a voluntary one: if competence increases with tenure (i.e learning effect), then auditor competence is likely to be relatively lower with a consequent negative impact on audit quality (Cameran, Trombetta, Prencipe, 2011). Moreover, in a mandatory rotation regime, towards the end of the engagement, the auditor will not be subject to the pressure of securing rents from future reappointments with the same clients as the engagement is terminated by law. However, as stated by Elitzur and Falk (2004), reputational issues and litigation threats should also be taken into consideration. Therefore the final effect is still uncertain. There are only few papers that directly analyze the impact of the rule within mandatory audit firm rotation settings.

Ruiz-Barbadillo, Gomez-Aguilar and Carrera (2009) provided evidence that the likelihood to issue going concern opinions to stressed clients was lower during the mandatory rotation regime in Spain[2] than during the years following that period. Cameran, Prencipe and Trombetta (2009) provided evidence concerning the mandatory rotation regime in Italy[3] suggesting that audit quality, measured in terms of earnings management, tends to increase with auditor tenure (consistently with the above mentioned stream of literature). Livne and Pettinicchio (2011), still focusing on the Italian setting, documented that benefits, in terms of better audit quality, can be associated to audit partner but not to audit firm rotations. Moreover, a very simple test conducted in the Italian setting, considering listed companies for which MRR is enforced, analyzed the relationship between the number of audit partner suspensions motivated by the fact that auditing standards are not properly applied and auditor tenure from 1992 to 2010 (Cameran and Pettinicchio, 2011). Table 1 shows that the number of partner suspensions in the first year of engagement is much higher compared to all other years. In particular, out of a total number of 52 year-suspensions, 16 referred to first-year engagements. A possible explanation may lie in the information asymmetry at the initial part of the auditor-client relationship that is usually quite high, as the incoming auditor need to get familiar with the business, accounting system, internal controls of the new client. Therefore, the risk of material errors/mistakes is generally quite high. Given these results, audit firm

[2] Spain has introduced the mandatory rotation rule and subsequently dropped it.
[3] Italy represents a good research setting where to study the effects of the mandatory rotation rule as the latter was introduces back in 1974

changes seem to increase the probability of audit partner suspensions due to audit quality problems.

Table 1: Partner suspensions in Italy (1992-2010), issued by Consob[4]



Source: Cameran and Pettinicchio, 2011

Another claimed beneficial effect of MR is related to the enhancement of audit market competition. Most of the European audit markets can be defined as oligopolistic since the supply of audit services is dominated by four big international audit firms (so called Big 4). Mandatory rotation, by imposing the auditor switch after a specific number of years, may have a positive effect on audit competition. Cameran and Pettinicchio (2011) compared the market shares of Big audit firms in mandatory and voluntary rotation regimes, through time. In particular, the authors compare the Italian Big N audit market share within the segment where the MRR is enforced and where the MRR is NOT, and the Big N audit market share for listed companies in Italy (where the MRR is enforced) with those of other European countries

[4] Consob is the Italian equivalent of SEC.

(where the MRR is NOT enforced) for which data is available and homogeneity issues permit a significant comparison (i.e. Spain, UK, Germany, Belgium and the Netherlands). Results show that Big audit firm market shares in mandatory rotation regimes are usually higher or not significantly lower than voluntary regimes (e.g. see Table 2), suggesting that the mandatory rotation rule does not necessarily increase audit market competition.

Table 2: Big N market shares (Belgium, The Netherlands, and Italy)

Year	Italy	Belgium	The Netherlands
1999	90.3 %	56.9 %	92.5 %
2000	88.9 %	60.6 %	88.1 %
2001	86.3 %	60.8 %	89.3 %
2002	87.7 %	64.9 %	89.2 %
2003	84.2 %	60.4 %	85.4 %
2004	83.3 %	51.4 %	83.9 %

Source: Cameran and Pettinicchio, 2011[5]

Even if the actual empirical effects on mandatory rotation are not still clear, one cannot rule out the possibility that the introduction of the rotation requirement might have positive potential effects on investors' confidence.

Daniels and Booker (2005) provide evidence that loan officers consider auditors much more independent when rotation is mandatory. Similar results were found in the SDA Bocconi School of Management report that in 2002, and in a 2004 update, studied the impact of mandatory audit firm rotation in Italy (SDA Bocconi School of Management, 2002). A survey carried out in 2001 provide evidence that the majority of managers and of the members of the

[5] Data, was provided by the authors of the study "Francis J.R., P. Michas and S.Seavey, 2010. Big four audit market concentration and client earnings quality around the world". Working paper, University of Missouri-Columbia.

“Collegio Sindacale[6]” of Italian listed companies believe that frequent rotations have a positive impact on auditors independence.

Finally, it should be highlighted that academic research has so far ignored the cost side of the mandatory rotation rule. The mandatory audit rotation rule has a considerable impact upon the overall costs of audit services.

According to a SDA Bocconi School of Management report, this is true at least for the first few years of activities carried out in a new appointment. This report carried out an analysis that investigated the economic consequences correlated to a change in auditors in the Italian setting. It considered the costs sustained by the audit firms themselves, as well as, the direct and indirect costs for services sustained instead by auditees (SDA Bocconi School of Management, 2002).

From the auditors’ point of view, rotation leads to a loss of client-specific knowledge and of clients’ rents. A research underlined how “European Accounting firms estimate that their costs would be around 15% higher long-term levels in the case of the new client in a familiar industry, and around 25% higher for those in unfamiliar industrial sectors” (Ridyard and De Bolle, 1992).

Moreover, every “rotation” brings in different organizational “disruptions” as the audit team needs to be reallocated on new or existing engagements: this process, especially for big multinational clients might even cause negative impacts on the quality of the current audits if not properly managed. The SDA Bocconi School of Management report (SDA Bocconi School of Management, 2002) explains that during the first few years of a new appointment more man-hours are necessary, together with the implementation of more qualified resources than those usually employed during the auditing of financial statements in the following

[6] Collegio Sindacale (Board of Statutory Auditors) is a Board which has to monitor the proper administration of the entity and its compliance with laws and regulation with supervision duties over the company’s .

years. This “training period ” is never less than two to three years for complex groups that operate at an international level. Empirical research also highlighted how, during the first year of new engagement, “getting to know” the economy of the auditee can even lead to an increase of up to 40% in man-hours due to new appointments compared with the average amount employed in the years to come (interviews with Italian Big Audit Firm controllers).

Rotation also might cause costs for the auditee, caused by the greater amount of time devoted to interactions with the new audit firm by managers, personnel, and internal auditors, if any, that supply the necessary information to the audit firm on aspects concerning corporate governance, internal control systems, organisational structure, market relations, and so on. This, of course, might cause a significant investment of time and resources.

The above statement was made by every single manager from Italian listed companies that filled in the questionnaire proposed by SDA Bocconi School of Management (SDA Bocconi School of Management, 2002).

However, opinions on the impact of costs sustained by the auditee caused by changes in auditing firms in the Italian setting were more controversial. Answers about SDA Bocconi questionnaires differed greatly and were not always that easy to interpret. This could also be due to the fact that, perhaps, the questioned people do not distinguish implicit costs, arising for greater time devoted to the new audit firm and explicit costs, that is, the fee for services paid to the audit firm. Only 36% of the managers that filled in the questionnaire and 36% of the contacted “sindaci” held that auditing costs increased following a change in the auditor, whereas, most of the questioned people believed that these costs either did not change or even dropped.

The above reported results are explained by SDA Bocconi report (SDA Bocconi School of Management, 2002) on the basis of what the partners of the Big Audit Firms sustain. They unanimously held that in the case of changing audit firm at the end of their nine-year period, fees for services are similar or lower than those of the former auditor. These partners underlined the fact that in occasion of mandatory audit rotation, fierce competition arises around fees for services that seems to be in contrast with what the Antitrust deems right[7]. The limited amount of available data relative to offers made to some listed companies between 1996-1998 by potential auditors reported in SDA Bocconi report (SDA Bocconi School of Management, 2002), highlights how the auditor is selected on the basis of fee for services, demonstrating that appointments are given to the audit firms that ask for fees below the average charge.

To conclude, the actual beneficial effects in terms of enhanced audit independence and audit quality are still to prove, as empirical evidence so far has not yet provided a clear and definitive picture of which aspect between higher independence or lower client-specific knowledge, is dominating.

Even if from a psychological point of view the introduction of the mandatory rotation rule might positively influence investors' confidence, we believe that additional empirical evidence, especially on the costs (in terms of fees, organizational impact etc.) should be gathered in order to have a complete and informative view.

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[7] The Big Italian audit firms were condemned by the Italian Antitrust Authority for price fixing in 2000.

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