

Statement of David S. Ruder

Former Chairman of the Securities and Exchange Commission

Concerning Auditor Independence and Audit Firm Rotation

Submitted to the Public Company Accounting Oversight Board

March 15, 2012

PCAOB Rulemaking Docket Matter No. 37

Statement of David S. Ruder*

Former Chairman of the Securities and Exchange Commission

Concerning Auditor Independence and Audit Firm Rotation

Submitted to the Public Company Accounting Oversight Board

March 15, 2012

PCAOB Rulemaking Docket Matter No. 37

Introduction

This statement is submitted in response to a PCAOB Concept Release on Auditor Independence and Audit Firm Rotation (Release No. 2011-066, August 16, 2011) seeking comment on ways that auditor independence, objectivity, and professional skepticism could be enhanced, and in response to the announcement that audit firm term limits will be discussed at a PCAOB Public Meeting on Auditor Independence and Audit Firm Rotation on March 21-22, 2012.

Problems

In its August 31, 2011 Concept Release, the PCAOB reported that questions persist regarding auditor performance. It described concerns about conflicts created by a fee system in which the client pays the auditor for its financial statement opinion, possible auditor bias toward accepting management's perspectives, and alleged auditor failure to put the interests of investors before those of its client.

A Mandatory Audit Rotation Rule Should Not be Adopted

The release asked whether a mandatory audit firm rotation rule would meet the identified problems. It recited arguments supporting and opposing such rotation. In my opinion, the rule should not be adopted. Instead, the PCAOB should work closely with the accounting profession and the major audit firms to create incentives, procedures, and rules that will meet the objectives of auditor independence, objectivity, and professional skepticism. It should also work closely with corporate audit committees.

* Professor of Law Emeritus, Northwestern University School of Law; Chairman U.S. Securities and Exchange Commission, 1987 – 1989; Trustee, Financial Accounting Foundation, 1996 – 2002; Trustee, International Financial Reporting Standards Foundation, 2000 – 2005; Member, PCAOB Advisory Council, 2003 – 2009, Emeritus Member, 2009 – present.

The Number of Large U.S. Auditing Firms Available for Rotation is Extremely Small

The auditing profession in the United States is dominated by four large accounting firms, each of which is larger than the next four largest auditing firms combined. These Big Four firms audit most of the largest U.S. companies, many of which have extensive international operations. These firms have various degrees of expertise and experience in particular industries. Each of them engage to some extent in non-audit services for companies they do not audit, services that may prevent them from acting as independent auditors for current non-audit clients. The combination of issuer size and international operations, audit firm specialization, and audit firm engagement in non-audit services makes it likely that the choices for new auditors of large U.S. companies will be severely limited. As a result, an audit firm rotation rule will be very hard to implement.

The Reasons Given for Adoption of a Mandatory Rotation Rule Are Not Persuasive

The primary reason given for adopting a mandatory rotation rule is that long-term relationships between auditors and their clients reduce auditor independence, objectivity, and skepticism. Assertions are that the auditor becomes cozy with management or that management is able to pressure the auditor. Another theory suggests that a new auditor will have special insights into the mechanics of its audit assignment. This theory, like the management pressure theory, assumes that the departing auditor did not behave responsibly during its long tenure as auditor.

These and other theories seem to suggest that auditors are not motivated to perform their tasks in accordance with the goals of their profession and in satisfaction of the high expectations of the public. In my view, audit firm occasional failures to meet high expectations are due to organizational and procedural inadequacies, rather than lack of will.

The PCAOB, the Auditing Profession, and Audit Committees Should Work Together to Improve the Audit Process

The announced PCAOB goal of enhancing “auditor independence, objectivity, and professional skepticism” is at the heart of the PCAOB’s mission. Instead of adopting a mandatory audit firm rotation rule, the PCAOB should use its powers to increase the internal quality controls of the audit profession. It should explore with the audit firms ways in which the profession itself can enhance auditor independence, objectivity, and professional skepticism. It should make increased demands on the audit firms for self-reporting on quality controls. It should use its inspection powers to validate claims of quality control. Both privately and publicly it also should pro-actively advise the firms about actions it believes should be taken.

An additional promising area for increase in audit effectiveness stems from current changes in audit firm supervision mandated by the Sarbanes-Oxley Act. Today management's influence over auditors is diminished because independent audit committees have power to hire and compensate auditors, and have strong oversight powers.

Although the PCAOB does not have direct supervisory power over audit committees, it does have the power to change and enforce audit requirements. It should use these powers to require audit firms to report on audit committee effectiveness. It should also engage in conversations with corporate audit committees in order to assist those committees to more effectively carry out their responsibilities. It should involve the auditing profession in these conversations.

Conclusion

In passing the Sarbanes-Oxley Act of 2002 Congress considered and rejected mandatory audit firm rotation and instead required a five year rotation of audit partners. It recognized the benefits of preserving the expertise and knowledge of the long term audit firm, but it also granted the PCAOB extensive power to regulate the auditing profession. Instead of requiring mandatory audit firm rotation, the PCAOB should utilize its extensive knowledge regarding audit practices and work closely with audit firms and audit committees to increase audit effectiveness.

David S. Ruder
Professor of Law Emeritus
Northwestern University School of Law
357 East Chicago Avenue
Chicago, IL 60611-3069
312-503-8444
312-503-2930 - facsimile
d-ruder@law.northwestern.edu