PCAOB
Public Company Accounting Oversight Board

Public Meeting on
Auditor Independence and Audit Firm Rotation
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Opening Remarks
by
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Concept Release on Auditor Independence and Audit Firm Rotation

- I thank the Board for inviting me to comment on
  - Whether imposing mandatory auditor rotation (MAR) would
    - Significantly enhance auditor's
      1. Independence
      2. Objectivity, and
      3. Professional skepticism

Longer Audit Firm Tenure: Costs

- What are the <u>costs</u> from having audit firms serve clients over longer periods?
  - Long association might lead to a loss of independence and a possibility that audit firms might acquiesce to management pressures
    - Net result is an erosion in audit quality and
    - Lower earnings (financial reporting) quality

Longer Audit Firm Tenure: Benefits

- **What are the <u>benefits</u> from having audit firms serve over longer periods?**
  - Greater investments in client specific knowledge
  - Greater investments in industry specific knowledge
    - Therefore, higher audit quality and higher earnings (financial reporting) quality.
    - Why?
      - Auditors get higher returns from investments in specialized knowledge through future fees from the same client
      - The analogy is similar to R&D investments and subsequent rewards from patents with the exception that in this case clients are free to switch auditors so auditors must render higher audit quality to retain their client
  - What are the <u>consequences of specialization</u> by auditors?
    - Rewards from capital markets
      - Clients benefit from auditor specialization as capital markets reward firms with superior audit quality by expecting lower cost of capital because “information risk” is lower.

Longer Audit Firm Tenure: Net Benefits

- **Do the <u>benefits</u> outweigh <u>costs</u>?**
  - The answer from research is overwhelmingly <u>YES</u>
- **Evidence from academic research**
  - Studies directly examining mandatory audit firm/partner rotation
    - 25% find MAR will improve auditor independence and audit quality
    - 75% find MAR <u>will not</u> improve auditor independence and audit quality
  - Studies directly examining longer auditor tenure consequences
    - 24% find longer tenure erodes auditor independence and audit quality
    - 75% find longer tenure <u>does not</u> erode auditor independence and audit quality
  - Based on perceptions, studies find that capital market participants perceive audit quality as improving with longer tenure
    - This result is important result as a key role of the SEC and PCAOB is to protect the interests of shareholders who appear to value longer tenure

Potential Consequences of Mandatory Audit Firm Rotation

- **Given the stylized facts, what happens if you impose "mandatory auditor rotation"?**
  - Benefits from longer auditor tenure are lost
  - Costs may decline but the net result is likely to be a decline in audit quality relative to a regime with mandatory auditor rotation
    - Even if audit quality does not decline, it is unlikely to improve as projected
  - Audit fees will increase because of higher fixed costs borne by audit firms that result from rotation
  - If clients use only Big 4 auditors, and all Big 4 auditors are equally competent, rotation is unlikely to bring in added benefits

Potential Other Solutions The Board Might Want to Consider

- So what is an <u>optimal</u> solution?
  - Benefits of tenure are not lost but potential costs are reduced?

- There are <u>some solutions</u> that the Board might want to consider (as alternatives to MAR)
  1. ***Disclosure requirement***
     - Firms required to <u>report audit engagement length</u> on proxies and 10-K reports
       - Currently this information is not disclosed and hard to obtain from prior years
         - » Audit firms would rationally pay attention to adverse effects of tenure once they are publicly disclosed
         - » Clients firms would be less likely to pressure audit firms with longer tenure because it might be easier for capital markets to infer causality when this information is publicly disclosed
  2. ***Limit extreme tenure***
     - If the Board is convinced that MAR is optimal, <u>limit maximum tenure</u> rather than imposed MAR
     - Limit very long tenures (e.g., greater than 25 or 30 years)
  3. ***Disclosures from audit committees***
     - Meeting with auditors
     - Basis for the choice of an auditor
     - Comment on audit fees and considerations that lead to the choice of an auditor
     - Why was the auditor not retained or retained