PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

Public Meeting on Auditor Independence and Audit Firm Rotation

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My name is Richard L. Kaplan and I am a professor of law at the University of Illinois where I have taught since 1979. Among my teaching responsibilities has been a semester-long course on "Financial Accounting for Lawyers," but my appearance this afternoon relates primarily to a law review article that I published in 2004 analyzing various provisions enacted in the Sarbanes-Oxley Act to enhance auditor independence.[1] That article was entitled "The Mother of All Conflicts: Auditors and Their Clients" and appeared in the *Journal of Corporation Law*. It can be downloaded without charge from the following website: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=556623.

In that article, I considered several provisions of the new law, including its requirement that auditors change their engagement and reviewing partners every five years. Against the backdrop of major corporate bankruptcies of Enron, Worldcom, Tyco and so many others, as well as my own audit experience with an international accounting firm, I concluded that this requirement was a step in the right direction, but only a small step. I suggested that to truly enhance auditor independence and financial statement reliability, the auditing firms themselves should be rotated periodically, and that is why I

[1] *See* Richard L. Kaplan, *The Mother of All Conflicts: Auditors and Their Clients*, 29 J. CORP. L. 363 (2004). Parts of this Prepared Statement have been adapted from that article.

am pleased to testify today on the Public Company Accounting Oversight Board's proposal.

As I explained in my 2004 article, mandatory audit firm rotation would not by itself solve the problem of auditor independence in a world in which auditors are hired, fired, and paid by the company they are auditing. As Board member Lewis Ferguson noted last August when the auditor rotation concept was proposed, "most creatures do not bite the hand that feeds them." But such rotation would fundamentally improve the situation and would counter to some degree the natural tendency of accounting firms to identify with their clients. As Board Chairman James Doty observed last August, when auditors seek to become "partners in supporting" the goals of their clients, auditor independence can give way to undue coziness, thereby undermining the "watchdog" function of auditors, as the Supreme Court styled it in *United States v. Arthur Young & Co.*[2]

That case remains the most explicit judicial characterization of what this hearing is all about:

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that

[2] 465 U.S. 805, 818, 105 S. Ct. 1495, 1503 (1984).

> the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.[3]

That is the charge that public accounting firms accept. It is certainly not an easy undertaking, but it remains the *raison d'être* of the legal requirement that public companies be audited. If the auditors are not willing to "maintain total independence from the client at all times," as the Supreme Court put it, there is little reason to have the audit at all.

At the same time, such pronouncements on the public responsibility of accounting firms ignore who pays the accounting firm's bills. If the "public" really wants accounting firms to look out for its interests, perhaps the public through its representatives in government should do the hiring and firing of auditors. After all, when the federal government wants to ensure that financial reports in the form of tax returns are correct, the government deploys its *own* auditors – namely, the Internal Revenue Service – who cannot be hired, fired, or paid directly by the persons being audited. In a world in which that approach is a nonstarter, however, the second-best solution is to make auditing firms as independent as possible, and mandatory firm-level rotation advances that goal.

A major shortcoming in the existing environment of auditing derives from the culture of accounting firms that partners confront. While major accounting firms have literally thousands of clients, individual audit partners typically have only a dozen major clients, often fewer. In that circumstance, the partner in charge of the audit is almost desperate to keep *all* of the clients in his/her stable. Losing one client over accounting

[3] 465 U.S. at 817-18, 105 S. Ct. at 1503 (emphasis in the original).

disputes would be very bad indeed; losing two would constitute professional suicide. In other words, it matters little that the accounting firm is huge with hundreds of large clients. At the level where the most important decisions are made regarding financial statement presentation and disclosures, the balance of power lies with the client.

Add to this economic pressure certain psychological tendencies to shade assessments in favor of the fee-paying client. One distinguished commentator described the auditor's quandary as follows: "When people are called upon to make impartial judgments, those judgments are likely to be unconsciously and powerfully biased in a manner that is commensurate with the judge's self-interest."[4] Consequently, auditors are prone to bias their conclusions to best preserve the client relationship that pays their bills, hardly a ringing endorsement of the cherished "independence" concept.

Into this conundrum came Section 203 of the Sarbanes-Oxley Act, which declared that:

> It shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer.[5]

The Securities and Exchange Commission interpreted this awkward phrasing to require that lead and concurring partners on a client audit change after five years and avoid

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[4] *See* Max H. Bazerman et al., *Opinion: The Impossibility of Auditor Independence*, SLOAN MGMT. REV. (Summer 1997), at 89, 91.

[5] Pub. L. No. 107-204, § 203, 116 Stat. 745, 773 (2002) (adding 15 U.S.C. § 78j-1(j)).

involvement with that audit for at least five years, a "time out" period in the Commission's charming lexicon.[6] The Commission, moreover, extended the rotation principle to any partner who had "significant involvement" with the client, but the time parameters are different. Instead of rotating after five years and then having a five-year "time out" period, these partners must be rotated off a client every seven years and then face a two-year "time out" period.[7]

But what about the staff auditor just below the partner who has been on the client's audit team for the past four years? If she is promoted to partner, may she then serve as the "lead" partner on that client's audit for the next five years? Her level of responsibility has changed, to be sure, but the problem of not getting a fresh set of eyes on the annual audit remains.

Moreover, five years (let alone seven years) is simply too long in today's fast-based business world. A relatively unknown company can become a financial powerhouse – at least on paper – much faster than was the case previously. Five years allows a dubious accounting practice to blossom into a major disaster, as some recent financial meltdowns have so painfully demonstrated. Given the increasingly significant implications for investors of all types, especially employees in self-directed pension

[6] Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. 6,006, 6,046 (Feb. 5, 2003) (codified at 17 C.F.R. § 210.2-01(c)(6)).

[7] *Id.* These rules parallel requirements adopted on October 2, 2002 by the Institute of Chartered Accountants in England and Wales to the effect that the "engagement partner"—but not the reviewing partner—must rotate after five years, and that other key audit partners must rotate after seven years. *See* Patrick Tracey, *U.K. Increases Audit Partner Rotation to Five Years to Improve Impartiality*, DAILY TAX REP. (BNA), Oct. 4, 2002, at G-3.

plans,[8] early detection of financial irregularities is critical. Accordingly, rotation periods for partners should probably not exceed two years.

In any case, these "musical chairs"- like requirements are all implemented within the *same* accounting firm. Little new perspective is introduced, since the newly rotated-in partners would have academic backgrounds and training experiences similar to the partners who rotated out. Whatever accounting firm culture contributed to an unwillingness to challenge a client's financial statement decisions in the past is unlikely to produce a different viewpoint simply because the specific individual players have changed positions.

Consider for a moment the position of the new partner on the audit. To a large extent, this partner will necessarily rely on the audit work performed by the staff person immediately below the partner level, especially if the client is in an industry in which the newly rotated-in partner had little previous experience. She will, therefore, need to be "brought up to speed," or educated in the workings of her new client, by the same person who has run the important below-partner level work during the previous several years. She may ask some new questions, but the tendency to defer to the explanations of experienced staffers will be substantial.

Moreover, this new partner is probably succeeding a more senior partner as lead partner on the audit engagement. In many cases, that more senior partner may be an object of intra-office respect and admiration, perhaps even veneration. That partner may even be the new partner's mentor, or served in that capacity at some earlier point in the

[8] *See generally* Richard L. Kaplan, *Enron, Pension Policy, and Social Security Privatization*, 46 ARIZ. L. REV. 53 (2004).

newly assigned partner's career. Given this context, how likely is it that the new partner will challenge the conclusions of her predecessor? How willing will she be to "rock the boat," or to challenge a client's financial reporting practices that had been condoned by her accounting firm in the past? Can she now contend that those practices have somehow morphed into unacceptable or unethical representations?

If we truly want a new perspective, public corporations should be required to switch auditing *firms* every few years. That approach is much more likely to provide a new perspective. In that situation, the new firm's engagement partner will be very comfortable challenging the work done by the previous auditor. Switching firms, moreover, would bring in an entirely new *team* of auditors, not just the final arbiter, to examine the corporation's financial practices and procedures. Rotating only the lead and reviewing partners within the same auditing firm gets the client some new eyes, but those new eyes still look through the same glasses.

And if, by some chance, those new eyes did raise uncomfortable questions about previous accounting practices, the auditing firm could simply reassign the questioner elsewhere and put some other partner in charge of this particular audit. After all, a long-term client relationship is far too important to be jeopardized by one "difficult" partner. Some other partner, one who "better understands" the client, would take over instead. In other words, long-term client relationships corrode the essential detachment that "auditor independence" requires. After decades of serving as a corporation's auditor, the accounting firm identifies with the client, substitutes trust for skepticism, and brags about the client to prospective recruits. The only effective way to counter this fatal "capture" is to rotate accounting firms according to some predetermined schedule. Merely rotating partners within the same firm is inadequate.

Audit firm-level rotation, by contrast, would align auditors' interest with those of financial statement users. Those new auditors would more readily question existing practices, because they have a professional incentive to ferret out or disagree with prior assessments. Indeed, the mere knowledge that a brand-new auditing team would be reviewing their work within a few years would have an undoubtedly salubrious effect on the company's current auditors. After all, they would know that their decisions might be second-guessed by someone with no careerist investment in going along with SALY ("same as last year"').[9] For that reason, the option to allow auditor engagement renewals should be resisted as well. A predetermined endpoint to the audit engagement is the closest surrogate to disinfecting sunlight that we are likely to achieve in this context. First-year audits are usually more comprehensive than subsequent-year audits, and the benefit of these more comprehensive audits is more often obtained by frequent turnover of auditing firms.

Might frequent turnover of audit firms increase audit fees? Perhaps, though reliable estimates are hard to find, and most projections are little more than talking points designed to dissuade policymakers from proceeding with mandatory auditor rotation.

But even if auditor rotation does increase costs, the critical question is whether there are offsetting benefits. At bottom, audits are largely superfluous when everything is as it appears to be. Audits are most necessary when financial statements are not

[9] *See* PCAOB Release No. 2011-006, Concept Release on Auditor Independence and Audit Firm Rotation, Aug. 16, 2011, at 17.

completely accurate. That is when lenders want to know what is really going on before they commit to additional lending activity. That is when employees need to know whether they should seek employment elsewhere or at least diversify their retirement account assets away from their employer's stock. If audit costs increase but those audits prevent financial deceptions, the cost-benefit tradeoff would favor auditor rotation. Anyone whose 401(k) plan became a 201(k) as a result of inadequate scrutiny of accounting practices by auditors has few qualms about conjectures regarding future audit expenses.

Finally, it is axiomatic that the Board should focus on enhancing auditor independence, objectivity, and professional skepticism – all of which would be improved by mandatory rotation of auditors. But second-order effects of auditor rotation might also be salutary, even if they are not within the Board's purview. Audit firm rotation would require more firms to develop industry-specific expertise, thereby expanding the potential job market for experienced auditors beyond a select few firms, as is the case presently. Similarly, second and third-tier accounting firms might grow into top-tier firms as they secure audit engagements that had been previously locked in for multiple decades.[10] As a result, competition among realistically eligible auditing firms would increase, which in turn is likely to *lower* auditing fees going forward.

In conclusion, the time is ripe for mandatory auditor rotation, and I encourage the Board to pursue this important initiative to its eventual adoption.

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[10] *See id*. at 20 (noting that among the largest 100 companies, the average auditor tenure was 28 years); *see also* AUDIT ANALYTICS, AUDITOR TENURE, FINANCIAL OFFICER TURNOVER, AND FINANCIAL REPORTING TRENDS (2011), at 1 (finding that among the Russell 1000, more than 16 percent of companies had auditor tenure of 40 years or more).