Statement of

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To the

Public Company Accounting Oversight Board

Regarding Auditor Independence and Auditor Rotation

San Francisco CA

June 28, 2012

It is a great honor to speak with you this morning. My name is Maureen McNichols and I am the Marriner S. Eccles Professor of Public and Private Management and Professor of Accounting at the Stanford Graduate School of Business. I earned my Bachelors and Masters' Degrees in Accounting from the University of Illinois, passed the CPA exam after my undergraduate program, and continued on to complete my Phd in Accounting at UCLA. I joined the accounting group at Stanford in 1984 and have taught a number of courses on financial reporting, financial statement analysis and investing over the past 28 years. My students and I have studied the financial reporting issues at many well-known companies, including Sunbeam, Waste Management, Enron, IBM, Worldcom, Halliburton, AIG, Tyco, CIT and Fannie Mae. I also developed an elective for our students titled "Understanding Cheating" which draws on the literatures in accounting, economics, sociology, psychology, and education to understand the factors that contribute to cheating and corruption. In 2003, I founded the GSB's executive education program for corporate board members. I also served on the board of NetIQ, and was a member of their compensation and audit committees.

My research focuses on the role of accounting in providing information to investors in capital markets. My own research and the work of many others in accounting establishes that informative financial statements are crucial to the allocation of capital in our economy. Substantial research establishes that investors are informed by financial statements and that stock prices respond significantly to earnings announcements. My dissertation documents in addition that financial statements play a distinctive role in causing less favorable information to be revealed on a timely basis. This is in contrast to the aggregate of other sources of information to investors, including management and financial analysts.

In subsequent work, I and my coauthors as well as other researchers have examined the causes and consequences of earnings management. This research documents that investors experience significant losses when firms announce earnings restatements or other financial reporting quality issues. Furthermore, the evidence suggests that incentives to manage earnings are substantial and that in addition to investor losses, firms that manipulate to increase their earnings often overinvest in their business, increasing investor losses. In other research, my coauthors and I find that the ability to predict bankruptcy is also impaired when firms manipulate earnings. These findings indicate that the benefits of high quality financial statements are substantial. These findings also indicate that the potential to manipulate earnings is greatest where judgment is greatest.

I teach my students that financial statements reflect three elements, fundamental information about firms, measurement error and discretion. The greater the measurement error, the greater is the judgment required and consequently, the greater the potential for managers to exercise discretion over the measures and disclosures in financial reports.

We are at a point in our history where unprecedented levels of judgment about values enter our financial statements, and consequently, there is unprecedented potential for management's unintentional and intentional biases to influence financial statements. Furthermore, the level of judgment and discretion in financial reporting can only be expected to increase as businesses evolve and engage in ever more complex transactions and contractual arrangements, as businesses increase their global reach and as accounting standards converge globally.

While Sarbanes Oxley brought substantial reforms and improvements to the reporting process, it is clear from the PCAOB's reviews and from the financial crisis that audit quality is not what it needs to be. Furthermore, the financial crisis makes clear that the interconnected nature of corporations and financial institutions has increased the potential harm from audit failures by orders of magnitude.

Entering into this ever-more challenging environment are the auditors. The auditors are required to plan audit tests that allow them to state whether, in their opinion, the financial statements are presented in conformity with generally accepted accounting. SAS 1 requires that the auditor maintain independence in mental attitude in all matters relating to the audit, and this is crucial to allow financial statements to fairly present the results of operations and the financial status of firms.

The classic model of corporate governance is that shareholders appoint the board of directors who appoints management who hires employees and manages the firm. The independent directors on the audit committee appoint the auditor who acts on behalf of investors. In this model, investors are the principals in a cascade of principal-agent relationships. While the financial statements are the assertions of management and the audit committee bears a key responsibility to assess the reasonableness of critical accounting policies and judgments, auditors have access to information and the responsibility to assess materiality that may determine whether an issue comes to the audit committee or the board. Thus even in a world where all audit committees are fully aligned with investors' interests, lack of independence in the auditor can degrade the quality of the financial statements. In companies where directors are less than fully independent, or are not fully diligent, the auditor's role is even more critical.

However, when a firm hires its auditor, it is hard for the auditor to be truly independent. One has only to look at the common language describing this relationship to see this. Audit firms speak of the companies they audit as their clients. When you look at the websites of public accounting firms, you see language that describes how their purpose is to provide value to their clients and to build relationships, to help clients solve complex business problems and enhance their ability to build value. I believe public accounting firms were created to serve a different client, the investing public.

There is substantial academic research on the effect of conflicts of interest in many domains and the findings are very consistent. One example of this research studies whether analysts' research reports are affected by investment banking and other types of relationships.[1] The findings indicate that affiliated analysts issued more favorable recommendations than unaffiliated analysts. The findings on scientific research are similar, and indicate that when scientists consult to companies, their research results are more favorable on average to the company. Research conducted by Max Bazerman and his colleagues provides strong evidence that in many cases these biases may be unintentional, rather than intentional.

The Sarbanes Oxley reforms have been fully implemented and substantial concern remains regarding the ability of auditors to remain appropriately skeptical of company assertions. I believe the lack of skepticism results from the structure of the "client-payer" model, and it is now time to pursue alternatives to the current model where the company being audited hires its auditor. I therefore support developing a plan that provides some form of term limit or mandatory rotation for auditors.

Managers are more likely to manage their financial statement numbers when it is less likely that manipulation will be detected and disclosed. Auditors are less likely to question a management judgment if a client relationship is at risk. Knowing that another firm will be reviewing their work increases the cost to the auditor of failing to appropriately exercise judgment. Auditor rotation means that early in a term, the incumbent's work is scrutinized by the successor and material errors that are found are likely to be corrected because they were not permitted by the successor. Similarly, as the auditor moves toward the end of the term, the probability of review of audit procedures and any breach or error increases significantly, and this increases the incentive to conduct a high quality audit.

Some may argue that research in accounting calls these arguments into question, documenting a positive relation between earnings quality and auditor tenure. I would be reluctant to draw inferences about the effects of mandatory rotation from this research for several reasons. First, it is hard to control for the circumstances that lead to the early years of an audit. The early years could arise because the company is newly public, or because it recently chose to switch auditors, and for either reason its earnings quality could be lower than for firms with greater auditor tenure. Second, it is hard to separate longer auditor tenure

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[1] See Lin, H. and M. McNichols, "Underwriting Relationships, Analysts' Earnings Forecasts and Investment Recommendations," *Journal of Accounting and Economics*, January 1998.

from survivor bias in the firm. Third, the findings could reflect the fact that earnings quality contributes to auditor tenure rather than the reverse. Lastly, these studies cannot capture the counterfactual at issue, how auditors perform audits when they are not concerned with maintaining the revenue stream provided by the firm they are auditing, and when they know their work will be reviewed by a successor auditor.

So to conclude, I believe a form of auditor rotation is in the best interest of the investing public as it would strengthen auditors' ability to independently assess the reasonableness of management's measures and methods. This has the potential to improve the quality of audits, and to decrease the frequency and magnitude of manipulation and errors in financial statements.

The structure of the PCAOB gives you a unique opportunity to work with the auditing profession to meet the needs of its clients, the investing public. I thank you for taking on this very challenging issue on behalf of the investing public, and for allowing me to speak with you today.