

Auditing Standards Committee
Auditing Section – American Accounting Association

December 13, 2011

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Via email to comments@pcaobus.org

RE: PCAOB Rulemaking Docket Matter No. 37; PCAOB Release No. 2011-006; Concept Release on Auditor Independence and Audit Firm Rotation

Dear Board Members:

The Auditing Standards Committee of the Auditing Section of the American Accounting Association is pleased to provide comments on the *PCAOB Rulemaking Docket Matter No. 37; PCAOB Release No. 2011-006; Concept Release on Auditor Independence and Audit Firm Rotation*.

The views expressed in this letter are those of the members of the Auditing Standards Committee and do not reflect an official position of the American Accounting Association. In addition, the comments reflect the overall consensus view of the Committee, not necessarily the views of every individual member.

We hope that our attached comments and suggestions are helpful and will assist the Board. If the Board has any questions about our input, please feel free to contact our committee chair for any follow-up.

Respectfully submitted,

Auditing Standards Committee
Auditing Section - American Accounting Association

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Responses to Specific Questions in the Release

Section III- Part D

Should the board focus on enhancing auditor independence, objectivity and professional skepticism? How significant are the problems in those areas relative to problems in other areas on which the Board might focus? Should the Board simply defer consideration of any proposals to enhance auditor independence, objectivity and professional skepticism?

Auditor independence, objectivity and professional skepticism are cornerstones of the audit profession and the PCAOB should continue to focus on improving them in the interests of capital market participants and users of financial information. Given the evolving changes in accounting standards and increasing regulatory requirements for financial reporting, the Committee feels that there is a greater need now for the Board to consider ways to help improve auditors' judgments and mindsets in facing new challenges to ensure that the financial statements continue to reflect a true and fair view of a company's performance, resources and liabilities.

The Committee also recognizes that independence, objectivity, and professional skepticism are difficult to define and even harder to evaluate (other than when they are obviously lacking). Thus, any regulation is easily justified by simply waving at these concepts because nobody would argue against improving independence, objectivity and skepticism. So while they are certainly worthwhile goals, they are much more problematic as a guide to better practice, especially through regulation. The Board would be well served to pause and consider not just if more regulation is needed but why current regulation is not achieving the desired level of independence, objectivity, and professional skepticism.

Would audit firm rotation enhance auditor independence, objectivity and professional skepticism?

A mandatory audit firm rotation proposal is premised on two assumptions: 1) a long term relation between a company and its audit firm would impinge on the auditor's independence and impair their ability to be objective and neutral, and 2) mandatory audit firm rotation would resolve problems (if any) associated with long term association between companies and their audit firms. The Committee believes that while mandatory rotation could lead to an increased perception of auditor independence, objectivity and professional skepticism, there is no evidence or research that supports the PCAOB's conjectures.

Two recent studies performed subsequent to the passage of the Sarbanes-Oxley Act (e.g., Myers, Myers and Omer 2003; Kaplan and Mauldin 2008) provide additional reasons to question the need for and benefit of mandatory audit firm rotation. In a sample of firm-years from 1988 to 2000, Myers, Myers and Omer (2003) do not find evidence that supports the concern of lower audit quality associated with longer auditor tenure. Instead, they document *higher* earnings quality associated with longer auditor tenure. They suggest that in the current audit environment, auditors with longer tenure, on average, put greater constraints on extreme management decisions in financial reporting, thus providing evidence contrary to the claim that earnings quality deteriorates with extended auditor tenure.

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Kaplan and Mauldin (2008) use an experimental setting to examine non-professional investors' judgments regarding audit firm rotation compared to audit partner rotation. The experiment finds no significant differences in non-professional investors' beliefs about auditor independence between a group that evaluated a five-year audit firm rotation versus a group that evaluated five-year audit partner rotation (already required by SOX). In other words, investors' independence judgments for auditors are not incrementally different for audit firm rotation above and beyond the already required audit partner rotation. The already imposed partner rotation seems sufficient to create the same benefit of independence, objectivity and professional skepticism with no additional costs. Additional analyses also suggest that non-professional investors seem to believe that auditors are more likely to be independent in the presence of a strong audit committee.

The Committee further feels that mandatory rotation can present a serious obstacle to auditors in conducting their independent and objective examination of the financial reports. Companies may be reluctant to share information about future business plans that may have accounting implications with an outgoing auditor.

What are the advantages and disadvantages of mandatory audit firm rotation? If there are potential disadvantages or unintended consequences, are there ways a rotation requirement could be structured to avoid or minimize them?

Limited academic research suggests that mandatory audit firm rotation may have more potential disadvantages and unintended consequences than advantages. These issues relate to audit quality, audit costs and audit specialization.

Audit quality

One of the consequences of mandatory rotation could be an increase in the number of audit failures. The 1987 Treadway Commission Report suggests that a significant number of financial frauds involved companies that had recently changed their auditor and others suggest a greater proportion of audit failures occurred on newly acquired audit clients (Berton 1991; Petty and Cuganesan 1996; Geiger and Raghunandan 2002; Johnson et al. 2002; Myers et al. 2003; Carcello and Nagy 2004; Stanley and DeZoort 2007; Davis et al. 2009; Gul et al. 2009)). Further, Palmrose (1986, 1991) documents greater litigation risk to auditors in the early years of an engagement, and the AICPA's Quality Control Inquiry Committee of the SEC Practice Section concluded that, in the 406 cases of alleged auditor failures between 1979 and 1991, that the Committee analyzed, audit failure occurred almost three times more often when the audit firm was engaged in its first or second year (AICPA 1992).

Audit costs

Mandatory rotation could have the effect increasing audit fees. The Cohen Commission concluded that fee and time budgets were serious concerns and would be exacerbated by putting auditors in situations where new clients are up for bid more often. There is both experimental and archival evidence that fee and time budget pressures can lead to reduced audit quality (Alderman and Deitrick 1982; DeZoort and Lord 1997; Coram et al. 2004; Ettredge et al 2011). Further, auditors consistently discount audit fees for new engagements an average of around 24% (Simon and Francis 1988; Ghosh and Pawlewicz 2009; Sankaraguruswamy and Whisenant 2009). Firms might stop discounting to cover the increased costs. If one considers an audit fee as

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a set of services bundled across time, then either the total expected fee must increase given the reduced payback period, or costs must decrease suggesting less effort and a loss of audit quality. The Committee assumes neither is acceptable.

The increase in costs will likely be substantial for large, multi-national firms with complex accounting issues given the steep learning curve. In addition, small firms will also bear a substantial burden, as a portion of the incremental audit fees involved with a new client are fixed and/or sticky. Collectively, the cost to U.S. client-firms for audit services will increase as a result of auditor rotation, and such costs will be passed on to shareholders and/or consumers.

Another factor to consider is that if audits go up for bid more often, large audit firms are better at bidding on new clients. In the case when large audit firms are capable of obtaining more new clients due to their effective bidding, the end result could be even more market concentration than we currently have now.

Audit specialization

Mandatory auditor rotation could have an unintended outcome of increasing a “myopic” view of a client by the auditor. That is, if an auditor knows that after 10 years, she will have to give up a client, would she have incentive to invest in the necessary audit quality, in expanding and improving its quality control systems, in developing better and deeper relationships with a client? It is possible that, as a result of mandatory auditor rotation, we will see a “commoditization” of audits. Some audit firms are specialized in certain industries, and mandatory rotation may result in a loss of that specialized knowledge. Munoz et al. (2001) show that broad experience facilitates accountants in developing appropriate knowledge structures while specific domain experience helps them maximize their performance. As documented by Shelton (1999), experienced auditors (audit managers and audit partners) are less likely to be influenced by irrelevant information in their judgment than inexperienced auditors (audit seniors). Further, investors and information intermediaries associate auditor tenure with higher audit quality (Ghosh and Moon, 2005), and auditors with longer tenure tend to place greater constraints on management’s discretion (Myers, Myers and Omer, 2003).

Audits could become much less client specific and more targeted to appeal to larger groups of clients in order to minimize switching costs resulting from mandatory rotations. Auditors may have to become much more generalist rather than specialist in nature if their audit firm does not have a large presence in a particular industry that would easily allow them to move across clients in the same specialty. Finally, recent regulatory financial reporting requirements like Sarbanes-Oxley (2002) and changing accounting standards (FASB/IFRS) have brought about an immediate and urgent need for audit specialists who have a more detailed understanding of a client’s industry and operations to adhere to financial reporting requirements. Mandating audit firm rotation at this juncture would add additional complications.

To minimize these overwhelming disadvantages of changing auditors, the PCAOB also needs to consider whether mandatory rotation should be accompanied by complementary changes to existing requirements. For example, if, as some have suggested, audit risk is greater in the early years of an auditor-client relationship due to the lack of experience with the client, the PCAOB should consider additional quality control or other procedures to mitigate that risk. Such procedures could include: (1) heightened internal supervision or oversight requirements for the

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first year or two of a new engagement and (2) increased required communications between predecessor and successor auditors and the sharing of working papers. Overall, the Committee feels that such steps, while necessary to mitigate the negative outcomes of mandatory rotation, would further increase the costs and burden to companies in trying to implement the new requirement.

Firm Rotation vs. Individual Auditor Rotation

Rotating auditing firms may not always lead to the rotation of individual auditors due to staffing constraints. For example, assume the Detroit office of Deloitte had to rotate off the audit of General Motors. The loss of this audit engagement would inevitably lead to a surplus of audit staff in the Detroit office of Deloitte. The addition of this engagement at another audit firm would inevitably lead to a shortage of staff in their Detroit office. Thus, auditors who specialize in the GM audit are likely to move to the new audit firm as a reallocation of resources at both firms would become necessary. It is well known that former Andersen auditors were hired by firms that picked up their Andersen clients. It is unlikely that the lead audit partner would come from another firm, but mandatory audit partner rotation is already in place. Small audits will not likely have a significant effect on staff turnover, but the rotation of large audit engagements could create a class of auditors who specialize in the audit of a specific company and rotate across firms with the audit client. Thus, it is not clear that mandatory firm rotation would have the desired effect on professional skepticism.

Because there appears to be little or no relevant empirical data directly on mandatory rotation available, should the Board conduct a pilot program so that mandatory rotation of registered public accounting firms could be further studied before the Board determines whether to consider developing a more permanent requirement? How could such a program be structured?

The Committee believes that PCAOB should conduct a pilot program if the PCAOB decides to implement a mandatory audit firm rotation policy. The PCAOB could initiate a long-term trial Voluntary Auditor Rotation program and modify it as needed during the trial period before adopting a permanent requirement. The PCAOB could urge audit committees and boards of directors to voluntarily rotate auditors every ten years or be required to file a statement with the PCAOB (on the audit firm's ten year anniversary with the client) outlining their rationale for the continued engagement of their long-term auditors.

The voluntary nature of the requirement would provide audit committees, boards and management teams that have legitimate reasons for not rotating auditors to explain those reasons to the PCAOB and to the public. By making this report a requirement, the PCAOB may symbolically, and perhaps actually, increase the ability of the audit committee to advocate for auditor rotation when prudent reasons dictate.

The voluntary nature of the audit firm rotation requirement would enable issuers with legitimate reasons for not rotating auditors to explain those reasons. The shareholders of the issuers can make their own determination about the legitimacy of reasons provided for non-rotation and communicate those reactions either directly to the issuer, indirectly through public comment, or indirectly through their investment decisions.

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Additionally, the Committee recommends that the Board undertake a study of mandatory audit firm rotation policies that exist at the state government level. For example, the state of Illinois requires all of its agencies to be audited annually by the Illinois State Auditor General who hires special assistant auditors. The special assistant auditors are independent certified public accountants who conduct financial and compliance audits of state agencies. By Illinois law, each agency must change special assistant audit firms every six years. One very small study of Illinois Universities that are audited under this six-year auditor rotation schedule found that auditors have the largest number of findings in the first year of the engagement and the fewest number of findings in the last year of the engagement (Simmons et al. 2009). This suggests some improvement in audit quality in the early years of the engagement. The low level of audit quality findings in the final year of the engagement are consistent with the auditor having a low level of motivation in the year prior to rotating off of an audit engagement. One additional point about the mandatory audit rotation policy in Illinois involves cooperation between the predecessor and successor auditors. The Illinois Audit Act specifies that the audit work papers prepared by the CPA firms are the property of the State. Therefore, newly hired audit firms have complete access to the details of previous audit findings. This reduces the start-up costs faced by the successor auditor.

While the regulatory environment is different for corporate clients and their auditors the Committee encourages the PCAOB to consider creative ways to reduce start-up costs, if the PCAOB decides to implement a mandatory audit firm rotation policy.

According to the 2003 GAO Report, large firms estimated that a rotation requirement would increase initial year audit costs by more than 20 percent. What effect would a rotation requirement have on audit costs? Are there other costs the Board should consider, such as the potential time and disruption impact on company financial reporting staff as a result of a change in auditors? Are there implementation steps that could be taken to mitigate costs? The Board is particularly interested in any relevant empirical data commentators can provide in this area.

Our response in a previous section addresses some of the issues. It is also important to remember that the true cost of auditor switching is larger than the audit fee, especially when the opportunity costs of manager and board time are considered.

A 2003 report by the Conference Board Commission on Public Trust and Private Enterprise recommended that audit committees consider rotation when, among other factors, "the audit firm has been employed by the company for a substantial period of time — e.g., over 10 years. To what extent have audit committees considered implementing a policy of audit firm rotation? If audit committees have not considered implementing such a policy, why not? What have been the experiences of any audit committees that have implemented a policy of rotation?

The Committee is not familiar with any research on experiences of audit committees that have implemented a rotation policy. However, the Committee agrees that the issue should be addressed with a survey of audit committee members.

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Are there alternatives to mandatory rotation that the Board should consider that would meaningfully enhance auditor independence, objectivity and professional skepticism? For example, should broader alternatives be considered that relate to a company's requirement to obtain an audit, such as joint audits or a requirement for the audit committee to solicit bids on the audit after a certain number of years with the same auditor? Could audit committee oversight of the engagement be otherwise enhanced in a way that meaningfully improves auditor independence?

The Committee believes that the audit committee should be more responsible for ensuring auditor independence, but does not have enough information on joint audits or a requirement for the audit committee to solicit bids on the audit after a certain number of years with same auditor to draw other alternatives.

Should the Board continue to seek to address its concerns about independence, objectivity and professional skepticism through its current inspection program? Is there some enhanced or improved form of inspection that could better address the Board's concerns? If mandatory rotation were in place, could an enhanced inspection, perhaps focused particularly on professional skepticism, serve as a substitute in cases in which it would be unusually costly, disruptive or otherwise impracticable to rotate auditors?

The Committee believes that the PCAOB should continue to address concerns about independence, objectivity and professional skepticism through its inspections to achieve similar results without broader economic costs. Mandating rotation not only increases the costs of audits overall but also creates uncertainty and disparity in audit quality. The PCAOB should focus its attention on the incentive audit partners have to relax professional skepticism. The incentive to relax professional skepticism relates to how the profitability of an audit engagement factors into an audit partner's compensation. An audit partner has an incentive to maintain good relations with the client, to reduce expenses related to the audit, and to minimize any impact of misstatements uncovered at the client. A profitable audit partner is not necessarily a professionally skeptical audit partner. Until those incentives align, there will be threats to auditor independence regardless of whether firms are required to rotate periodically. Rather than implementing a costly directive like mandatory firm rotation, the PCAOB may be better served by looking at individual incentive structures that lead to unintended reductions in professional skepticism. Until audit partners are evaluated on and rewarded for their professional skepticism, there will always be threats to professional skepticism.

It may be helpful to consider other professions and how they are rewarded for their professional skepticism. For example, a professional reporter makes a career for himself by uncovering a big story (e.g., Woodward and Bernstein). A professional prosecutor makes a career for herself by prosecuting high profile cases. However, audit partners are not rewarded in the same manner for being skeptical. It is an open question as to whether it is good public policy that auditors are as skeptical as investigative reporters or professional prosecutors but is a question worth asking.

IV. Possible Approaches to Rulemaking

A. Term of Engagement

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1. If the Board determined to move forward with development of a rotation proposal, what would be an appropriate term length?

If the Board determines to move forward with a rotation proposal the Committee suggests that the term should be long enough for the company to recover the additional “start-up” costs. The Committee recommends no less than 10 years.

2. Should different term lengths for different kinds of engagements be considered? If so, what characteristics, such as client size or industry, should this differentiation be based on?

If the Board determined to move forward, it would be advisable to have varying term lengths depending on the size of the audit engagement relative to the size of the audit firm (or the office where the audit is performed). In that way, it would be similar to differentiating between large accelerated filers, accelerated filers, and non-accelerated filers when assessing an appropriate filing window. Another factor to consider is the availability of suitable competitors with appropriate audit expertise. For example, if an audit engagement requires specialized industry knowledge and other audit firms in the city are not likely to have specialists in that area, then rotating audit firms would not be advisable.

Mandatory rotation could also be required for companies that have significant prior misstated financial statements, long tenure, and the PCAOB has identified significant issues that can reasonably be associated with tenure.

3. Does audit effectiveness vary over an auditor's tenure on a particular engagement? For example, are auditors either more or less effective at the beginning of a new client relationship? If there is a "learning curve" before auditors can become effective, generally how long is it, and does it vary significantly by client type?

As mentioned above, prior research suggests an association between the new audits and audit failures (Berton 1991; Petty and Cuganesan 1996; Geiger and Raghunandan 2002; Johnson et al. 2002; Myers et al. 2003; Carcello and Nagy 2004; Stanley and DeZoort 2007; Davis et al. 2009; Gul et al. 2009), but whether that evidence is applicable to mandatory rotation is not clear.

For those that currently rotate auditors voluntarily, the PCAOB could conduct a study (or sponsor one) that examines whether new client-audit relationship result in fewer problems, fewer audit adjustments, and fewer audit failures.

4. Some have also suggested that, in addition to being less effective at the beginning of an engagement, an auditor may be less diligent toward the end of the allowable term. On the other hand, others have suggested that auditors would be more diligent towards the end of the allowable term out of concern about what the replacement auditor might find. Would auditors become more or less diligent towards the end of their term? Does the answer depend on the length of the term?

The accountability literature would suggest that auditors would be more diligent towards the end of the audit. This is because auditors would feel greater accountability for the quality of their work when they know that another auditor will be replacing them in the next year. For instance,

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Lord (1992) finds that experienced audit managers were less likely to issue an unqualified opinion when they were made accountable for their decisions. Similarly, DeZoort et al. (2006) show that auditors who are under higher levels of accountability pressure by way of having to provide feedback and justification provide more conservative materiality judgments and have less judgment variability. However, the advent of PCAOB inspections and audit partner rotations plays the same role of increasing accountability without the loss of audit effectiveness and efficiency due to mandatory audit firm rotation. In fact, changing firms may reduce this sense of accountability as audit partners may feel more accountable to fellow partners (i.e., shame) than to unknown partners of another firm.

5. How much time should be required before a rotated firm could return to an engagement?

Considering the small number of audit firms that are truly available to large companies, setting a short period would be more reasonable. The start-up costs are sufficiently large that companies will most likely opt to keep the successor auditor for as long as they can before mandatory rotation. Thus, the PCAOB should not unduly further restrict firms' choice of auditors.

B. Scope of Potential Requirement

6. Should the Board consider requiring rotation for all issuer audits or just for some subset, such as audits of large issuers? Should the Board consider applying a rotation rule to some other subset of issuer audits? For example, are there reasons for applying a rotation requirement only to audits of companies in certain industries?

As previously discussed, the Board should consider if viable alternatives exist for each audit client based on industry and location. Negative unintended consequences to mandatory audit firm rotation are likely positively associated with client size and industry specialization. In other words, the audit quality of large audit clients in specialized industries is more likely to suffer from mandatory audit firm rotation.

C. Transition and Implementation Considerations

7. To what extent would a rotation requirement limit a company's choice of an auditor? Are there specific industries or regions in which a rotation requirement would present particular difficulties in identifying an auditor with the necessary skills and expertise? Is it likely that some smaller audit firms might decide to leave the public company audit market due to the level of uncertainty regarding their ongoing client portfolios?

As discussed above, the market concentration and loss of specialization are possible disadvantages of the mandatory rotation rule.

8. If rotation would limit the choice of auditors, are there steps that could be taken to allow a company sufficient time to transition out of non-audit service arrangements with firms that could be engaged to perform the audit? Are there other steps that could be taken to address any limitation on auditor choice?

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Consider the example whereby a company uses PwC for audit services and EY for non-audit services. If rotation requires, the company to rotate away from PwC, the company must either choose (assuming only Big 4 is option) from KPMG and Deloitte or must also switch its non-audit service provider to include EY as a potential audit provider.

An indirect cost to audit firms is that companies may choose to hire consulting (versus audit) firms to provide non-audit services to avoid the above loss of choice. This potential reduction of consulting services from Big 4 audit firms might represent an additional positive step supporting auditor independence, however may lead audit firms to shy away from performing audit services.

A transition period allowing one firm to perform both audit and non-audit services does not seem to be consistent with the goal of increased auditor independence (to the extent that one believes joint provision reduces independence).

9. If rotation were required, would audit firms have the capacity to assign appropriately qualified personnel to new engagements? If they do not currently have that capacity, could firms develop it in order to be able to compete for new clients, and would they do so?

If the Board determined to move forward, then it would need to effectively manage the transition to avoid mass rotation in a single year and allow firms to structure plans to transition effectively and prevent any capacity issues.

10. Would rotation create unique challenges for audits of multinational companies? For voluntary rotations that have taken place, what have been the implementation and cost issues and how have they been managed?

11. Would increased frequency of auditor changes disrupt audit firms' operations or interfere with their ability to focus on performing high quality audits? How would any such disruption vary by firm size? For example, would a rotation requirement pose fewer or more implementation issues for small firms than for large ones?

12. Would audit firms respond to a rotation requirement by devoting fewer resources to improving the quality of their audits? Would firms focus more on non-audit services than on audit services?

There is no empirical data on how auditors adjust their revenue mix in response to regulatory changes.

Hypothetically, in response to the restrictions of the mandatory audit firm rotation, auditors could start switching to providing non-audit services, which would not be subject to auditor rotation requirements. However, in our view, it is unlikely that such changes would be massive since the accounting firms had to significantly downsize their consulting practices following independence scandals of early 2000s and as a result of passage of Sarbanes-Oxley Act. Auditing will be their “bread and butter”, regardless. The question is whether mandatory auditor rotation could negatively affect accounting firms’ investments into their audit practices.

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Here is the breakdown of the total fees paid during 2000-2010 period by the type of the accounting firm using Audit Analytics and Compustat data.

Firm	Aggregate audit fees during 2000-2010	Aggregate Non-Audit fees during 2000-2010
Arthur Andersen (before dissolution)	\$ 837,242,778	\$ 1,647,635,089
Ernst and Young	\$ 21,861,321,402	\$ 8,423,968,775
Deloitte	\$ 20,272,753,804	\$ 8,413,020,382
KPMG	\$ 18,439,156,932	\$ 6,827,805,949
PwC	\$ 28,177,819,504	\$ 13,551,710,365
All others	\$ 4,193,322,039	\$ 915,698,827
Total	\$ 93,781,616,459	\$ 39,779,839,387

As can be seen, for almost all firms used to compute these statistics, with the exception of Arthur Andersen, audit fees significantly exceed non-audit fees; in aggregate, audit fees exceed non-audit fees by a ratio of about 2.3:1. It is hard to imagine that there will be a wholesale switch from provision of audit services to provision of non-audit services even if mandatory rotation is instituted. In addition, we are aware of no empirical evidence that would suggest that auditors switch to greater provision of non-audit services as a result of natural rotation (i.e. resignations and dismissals of auditors).

However, it is possible that over time, we could see a recurring trend to growth of non-audit practices within accounting firms since those practices will not be subject to mandatory rotation requirements. If indeed accounting firms were to turn more aggressively to provision of non-audit services when faced with rotation demands, one possible positive externality of that would be clients' greater ability to acquire non-audit services from other firms, since under current SOX provisions, firms are prohibited from providing many types of non-audit services, and any provision of any permitted non-audit services has to be approved by the audit committee (Chen et al. 2008).

Regardless of what may happen, one could still ask a reasonable question, whether provision of non-audit services by itself is “bad”? Research evidence on this is mixed; however, it seems that the majority of studies support the view that non-audit services are not necessarily harmful. With respect to negative evidence, prior research provides some evidence that non-audit services result in greater economic bonding between auditors and their clients. In particular, auditors are less likely to resign from clients paying higher non-audit fees; this effect is less pronounced after adoption of the Sarbanes-Oxley Act (Chen et al. 2008). Correspondingly, clients are more likely to fire auditors that charge higher audit fees; this effect is more pronounced among smaller clients (Ettredge et al. 2007). Non-audit fees can also have positive “spillover” effects whereby knowledge gained from non-audit services provided helps improve quality of audit engagements. For example, Lim and Tan (2008) show that this spillover effect is more pronounced amongst specialist auditors. One potential explanation for this is that industry specialists benefit more from knowledge gleaned from non-audit services (for example, IT work), and thus can more efficiently transfer such learning to their audit engagements. However, Frankel et al. (2002) also

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raise a possibility that non-audit services may have negatively affected auditor objectivity in pre-SOX period, as manifested in a higher level of earnings management. Ferguson et al. (2004) find similar evidence of a positive association of earnings management and non-audit services in the UK market. At the same time Frankel et al.'s work has been challenged by several other studies that failed to find a similar relation between non-audit fees and earnings management (e.g. Ashbaugh, et al. 2003, Chung and Kallapur, 2003, Larcker and Richardson, 2004).

Hence, it seems that while some studies support the view that non-audit services increase the level of economic bonding with clients, no clear evidence exists supporting this view. Non-audit services could also be beneficial in terms of "knowledge spillovers". Thus, even if accounting firms increase their investments into non-audit services, research does not provide clear evidence that this will be undesirable.

Because non-audit fees tend to originate more from highly specialized projects and have been blamed for being more lucrative (Chen et al. 2008), we can see a renewed trend to invest more human and physical capital into non-audit services in general. In other words, mandatory audit firm rotation could contribute to a change in the general profile of an accounting firm to more of a consulting or an advisory service, where auditing will be less dominant. However, this change will likely take a very long time. If this occurs, it is hard to tell whether such a change will be necessarily negative. That will depend on the relative trade-off between benefits of mandatory audit firm rotation in a form of greater auditors' objectivity and independence, and a possible long-term cost of under-investment into auditing services.

13. Would rotation have any effect on the market for non-audit services? Would any such effect be harmful or beneficial to investors?

14. Some have expressed concern that rotation would lead to "opinion shopping," or that in competing for new engagements firms would offer favorable treatment. Others have suggested that rotation could be an antidote to opinion shopping because companies would know that they could not stick with a firm promising favorable treatment forever. Would opinion shopping be more or less likely if rotation were required? If rotation limits auditor choice, could it at the same time increase opinion shopping?

15. What effect would a rotation requirement have on competition for audit engagements? If competition would be increased, how might that affect audit quality?

Mandatory rotation might have both short- and long- term effects on competition. In the short-term, it might force increased competition. However, in the long-term, companies will have at least one less audit firm from which to choose each year of rotation. In addition, if firms choose to switch their primary function from the performance of audit services to non-audit services, companies will also lose the number of firms from which to choose.

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