

Letter of Comment on Auditor Rotation

Prepared For the Public Company Accounting Oversight Board

(PCAOB)

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**Docket 037 : Concept Release on Auditor  
Independence and Audit Firm Rotation**

## Executive Summary

We appreciate the opportunity to provide feedback for review on The Public Company Accounting Oversight Board Rulemaking Docket Matter No. 37-Concept Release on Auditor Independence and Audit Firm Rotation. While we support the ongoing effort by PCAOB to enhance auditor independence and to ultimately increase audit quality, we have concluded that mandatory audit firm rotation, in and of itself, will not achieve those objectives. The implementation of mandatory audit firm rotation poses many possible outcomes that will affect not only the firms conducting the audits and their shareholders, but also the interests of the general public and society. The proposed requirements will increase costs and inefficiencies for the large accounting firms, which would negatively affect investor interests. Furthermore, we have found no conclusive evidence that demonstrates that higher quality audits result from the implementation of a mandatory firm rotation. We believe that the PCAOB should investigate a more comprehensive, holistic approach to the problem of audit failure. If auditor rotation is to be implemented, it should be part of a larger plan to increase competition in the audit market and to ensure that auditing firms uphold their obligations to maintain independence and to conduct audits with an attitude of professional skepticism. The PCAOB should also consider some of the reforms being discussed by the European Union, such as the use of joint auditors to address the audit market issues. As accounting and auditing are conducted in the global arena, the convergence of accounting standards will necessitate a convergence of international regulations as well.

### **About Castleton College**

Castleton, a Vermont State College, is among the oldest institutions of higher learning in the United States. Founded in 1787, Castleton offers liberal arts and professional education in an environment that emphasizes community involvement and responsible citizenship. As members of Castleton's inaugural Master of Science in Accounting program, we believe that it is both an honor and a duty to become involved in the future of our chosen profession. We appreciate the opportunity to offer our opinions on the issue of mandatory auditor rotation and hope that the perspective of those about to enter the profession will be of interest and help to the members of the PCAOB in arriving at their conclusion on the matter.

### **Costs Associated with Mandatory Rotation**

The overall increase in costs associated with the more frequent change in auditors that would occur if mandatory audit rotation were to be implemented would be substantial. The resulting cost increase would be to both the public accounting firms and the public companies. According to the Government Accountability Office (GAO), the significant costs would include:

- Marketing costs-Utilized to acquire and or maintain financial statement audit clients
- Audit Costs-The costs incurred by public accounting firms to perform audits
- Audit Fee-The amount a public accounting firm charges to perform audit
- Selection Costs-Cost incurred by public company in selecting new accounting firm
- Support Costs-internal costs of public company to support accounting firm's effort to understand company specific operations, systems, and reporting practices. (Office G. A., 2003)

In addition, 96 percent of the Tier 1 firms stated that their initial year audit costs are likely to be more than in subsequent years. The total estimated initial year audit costs would be increased more than 20 percent over subsequent years' costs. (Office G. A., 2003) Given the absence of evidence that auditor rotation improves audit quality, the additional cost does not appear to be justified. Rotation might provide a short-term fix by relieving auditors of management pressures in the beginning. With only four major firms, the original auditor will likely be back wooing and then auditing the client. There may also be more audit risk associated with auditor rotation. In the early years of an audit, the new audit firm engaged may not be as competent or as knowledgeable as a long standing audit firm.

### **The Auditing Market**

The dominance of the "Big Four" accounting firms not only in the United States but also internationally has become a major topic of concern. The debate centers on the overall anti-trust arguments against the formation of an oligopoly. If mandatory audit firm rotation were to be implemented, the strength of these four firms might actually increase, given the limited rotation. Mandatory audit firm rotation would require additional conditions in order to achieve the desired level of auditor independence sought by PCAOB.

The proponents of mandatory audit firm rotation state that it will increase opportunity for Tier I and Tier II firms to provide audit services to more public companies. Those against the move believe it will lead to the "Big Four" gaining a larger share of the market leading to less competition and higher fees. Lower Tier Firms may not have the capacity, expertise and capital

to compete with the “Big 4 Firms”. There is little incentive for a firm to put the capital into acquiring a public company audit client when the firm can only keep the client for a limited time.

Rules and regulations would have to be revised to encourage and allow the lower tier firms to enter the market. Many publicly traded companies and venture capitalist state in their by-laws and other legal documents, that their companies must be audited by one of the “Big 4 Firms”. Industries with specific needs already have few choices in auditors; few outside of the “Big 4 Firms” have the expertise for their industry. The Sarbanes-Oxley Act prohibits a firm from conducting certain non-auditing services while auditing a company, which further limits the company’s choices of their next auditor. Some specialty companies may have only one or two firms that have the expertise in that specific industry to do their audit and perform the required -audit services.

The lack of firms performing the larger public company audits could become a major constraint on auditor rotation. The “Big 4 Firms” control the majority of the market because of their capital, capacity to gain the certain expertise needed and the prestige of their brand name. The lack of more firms with these intangibles does not promote a free market. It limits the possibility for some companies to even be able to have a choice of firms to engage to perform their audit services. Many argue, including regulators in the European Union, that the only way for audit rotation to work is to break up the “Big 4 Audit Firms”. This would create a more even playing field and give clients more choices while promoting a free market environment.

### **The Joint Audit**

While we can appreciate the concerns about the lack of a free market for auditing services, the overall goal of reform is to enhance audit quality. The entry of more firms into the market could conceivably encourage “opinion shopping” or the practice of attempting to hire an auditing firm that will go along with questionable accounting practices. One way to mitigate the adverse affects of opinion shopping would be to require joint audits, whereby the Big 4 would be encouraged to work with medium sized firms in conducting audits. The idea is that joint audits would help expand the choice of auditors and help ensure audit quality. Joint audits are likely to increase audit costs. The addition of another firm to the mix may also increase objectivity and professional skepticism on the part of the auditors, thereby increasing audit quality. European regulators are also considering requiring audit firm rotation, but allowing a 9 year term (instead of a 6 year term) if the auditing firms provide a joint audit. (Chasan, 2011)

### **Increasing Accountability**

Lack of objectivity and professional skepticism are key deficiencies that are occurring in audits of all sizes. These deficiencies do not appear to be confined to a certain size of company or size of the audit firm. Nonetheless, audits of public companies are both a service to clients and a public good. Auditing firms can be considered to be part of our economic infrastructure. Our economy and our capital markets are based upon a system of trust. Improving the objectivity and professional skepticism of auditors cannot be accomplished simply by requiring the audit

firm to be rotated on a regular basis. The root of the problem seems to be that there is an industry-wide lack of commitment to objectivity and professional skepticism. This lack of commitment can be improved by creating an atmosphere of accountability and providing more oversight. We believe that if auditor rotation is to be adopted, that the European Commission proposal for voluntary joint audits with longer terms should be implemented to help ensure that audit quality is indeed improved. The PCAOB should also carefully monitor the results of any changes in audit rules to ensure that they are having the desired effect.

## Works Cited

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