

---

CONCEPT RELEASE ON AUDITOR INDEPENDENCE AND AUDIT FIRM ROTATION;	)	PCAOB Release No. 2011-006 August 16, 2011
NOTICE OF ROUNDTABLE	)	PCAOB Rulemaking Docket Matter No. 37

---

**Summary:** The Public Company Accounting Oversight Board ("PCAOB" or "Board") is issuing a concept release to solicit public comment on ways that auditor independence, objectivity and professional skepticism could be enhanced. One possible approach on which the Board is seeking comment is mandatory audit firm rotation, which is explored in detail in this release. However, the Board seeks advice and comment on other approaches as well. The Board will also convene a public roundtable meeting in March 2012, at which interested persons will present their views. Additional details about the roundtable will be announced at a later date.

**Public**

**Comment:** Interested persons may submit written comments to the Board. Such comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by e-mail to [comments@pcaobus.org](mailto:comments@pcaobus.org) or through the Board's Web site at [www.pcaobus.org](http://www.pcaobus.org). All comments should refer to PCAOB Rulemaking Docket Matter No. 37 in the subject or reference line. Comments should be received by the Board no later than 5:00 PM EST on December 14, 2011.

**Board**

**Contacts:** Martin F. Baumann, Chief Auditor and Director of Professional Standards (202/207-9192, [baumannm@pcaobus.org](mailto:baumannm@pcaobus.org)), Michael Gurbutt, Associate Chief Auditor (202/591-4739, [gurbuttm@pcaobus.org](mailto:gurbuttm@pcaobus.org)), and Jacob Lesser, Associate General Counsel (202/207-9284, [lesserj@pcaobus.org](mailto:lesserj@pcaobus.org)).

## **I. Introduction**

An audit has value to financial statement users because it is performed by a competent third party who is viewed as having no interest in the financial success of the company.<sup>1/</sup> Investors can take comfort in the fact that independent professionals have performed required procedures and have a reasonable basis for the opinion that the financial statements present fairly in all material respects an entity's financial position, results of operations and cash flows in conformity with generally accepted accounting principles.

The Sarbanes-Oxley Act (the "Act") included a number of significant provisions designed to bolster the auditor's independence from the company under audit. For example, for listed companies, the Act puts the audit committee—rather than management—in charge of hiring the auditor and overseeing the engagement. It also prohibits auditors from providing certain non-audit services to clients and imposes mandatory audit partner rotation. These and other reforms were part of Congress's response to financial scandals at Enron, WorldCom, and elsewhere. As another major part of that response, Congress established independent oversight of the auditing profession by the PCAOB for audits of issuers.

Since its creation, the Board has conducted hundreds of inspections of registered public accounting firms each year. These inspections provide the Board with a unique insight into the state of the audit profession and the conduct of public company audits. Based on this insight, the Board believes that the reforms in the Act have made a significant, positive difference in the quality of public company auditing. Yet, as described below, the Board continues to find instances in which it appears that auditors did not approach some aspect of the audit with the required independence, objectivity and professional skepticism.<sup>2/</sup> The Board addresses audit failures on a case-by-case basis through its inspection and enforcement programs. At the same time, it is also considering whether other approaches could foster a more fundamental shift in the way the auditor views its relationship with its audit client.

As described in detail below, one possible approach that might promote such a shift is mandatory audit firm rotation, which has been considered at various times since the 1970s. Proponents of such a requirement believe that setting a limit on the continuous stream of audit fees that an auditor may receive from one client would free the auditor, to a significant degree, from the effects of management pressure and offer an opportunity for a fresh look at the company's financial reporting. Opponents have expressed concerns about costs that changing auditors could impose on certain issuers. The risk of increasing issuer audit costs may be a consideration that merits particular discussion during a period of economic weakness and heightened global competition. Opponents have pointed to academic research and comment, discussed below, to argue that

audit quality may suffer in the early years of an engagement and that rotation could exacerbate this phenomenon.

In 2002, Congress considered requiring audit firms to rotate off an audit engagement after a set number of years during the debates that led to the Act. Instead, it decided that the idea required more study and directed the General Accounting Office ("GAO") to prepare a report. That report was issued the following year and concluded that "mandatory audit firm rotation may not be the most efficient way to enhance auditor independence and audit quality...."<sup>3/</sup> It also stated, however, that "more experience needs to be gained" with the Act's requirements and that "it will take at least several years for the SEC and the PCAOB to gain sufficient experience with the effectiveness of the act in order to adequately evaluate whether further enhancements or revisions, including mandatory audit firm rotation, may be needed to further protect the public interest and to restore investor confidence."<sup>4/</sup>

In the ensuing years since the GAO Report was issued, the global financial crisis has tested the credibility of the audit in the public mind once again. What is clear from the Board's inspections, as well as from the experience of other audit regulators, is that questions persist about whether more can and should be done to enhance auditor independence, objectivity and professional skepticism. As a result, proposals are being considered outside the U.S. for measures such as regulation of engagement tenders, mandatory rotation, dual-firm audits and "audit-only" firms.<sup>5/</sup>

In light of these considerations, the Board is soliciting comment on these issues, including, in particular, the advantages and disadvantages of mandatory audit firm rotation. Through this concept release and the comment process, the Board intends to open a discussion of the appropriate avenues to assure that auditors approach the audit with the required independence, objectivity and professional skepticism. The Board recognizes that a rotation requirement would significantly change the status quo and, accordingly, would risk significant cost and disruption. The Board is interested in commenters' views and data on those issues, including how cost and disruption could be contained, as well as on whether and how mandatory rotation would serve the Board's goals of protecting investors and enhancing audit quality. The Board also seeks comment on whether there are other measures that could meaningfully enhance auditor independence. Finally, this release also poses a number of more specific questions on which the Board seeks comment, including, for example, whether the Board should consider a rotation requirement only for audit tenures of more than 10 years, and only for the largest issuer audits.

## II. Auditor Independence

Accountants have long recognized that independence is critical to the viability of auditing as a profession.<sup>6/</sup> Few among auditors, preparers, financial statement users, or their legal advisors would seriously dispute the value of independent assurance on a company's financial statements. Yet, auditor independence remains subject to a significant inherent risk. The accounting firm is a for-profit enterprise that is paid by the company being audited to provide a service.

At the same time, and notwithstanding the relationship that provides him or her with a livelihood, the auditor must be an independent professional. The U.S. Supreme Court described the auditor's overriding duty to put the interests of investors first:

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 the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.<sup>7/</sup>

Unlike many other professionals, an auditor must, therefore, struggle against letting the inevitable pressures of client service interfere with his or her duty to serve the public.

Independence is both a description of the relationship between auditor and client and the mindset with which the auditor must approach his or her work.<sup>8/</sup> The most general of the independence requirements in the auditing standards provides: "[i]n all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors."<sup>9/</sup> One measure of this mindset is the auditor's ability to exercise "professional skepticism," which is described as "an attitude that includes a questioning mind and a critical assessment of audit evidence."<sup>10/</sup> PCAOB standards provide that "[i]n exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest."<sup>11/</sup>

Over time, Congress, the Securities and Exchange Commission ("SEC" or "Commission"), and, more recently, the Board have adopted requirements designed to foster the required state of mind and ban conduct deemed incompatible with independence.<sup>12/</sup> To some degree, these rules may be viewed as efforts to address the fundamental conflict created by the auditor-client

relationship.<sup>13/</sup> For example, out of concern that "[a]ccounting firms ha[d] woven an increasingly complex web of business and financial relationships with their audit clients," the SEC (and later Congress) imposed limitations on the kinds of non-audit services a firm may provide an audit client.<sup>14/</sup> Efforts to impose independence requirements such as these have been contentious.<sup>15/</sup>

These significant reforms have enhanced auditor independence and, along with it, the reliability of financial reporting. Based on the Board's inspections and other oversight activities, auditors still, at times, fail to display the necessary independence in mental attitude.

The Board has now conducted annual inspections of the largest audit firms for eight years. The Board's inspectors have reviewed portions of more than 2,800 engagements of such firms and discovered and analyzed several hundred cases involving what they determined to be audit failures. In this context, an audit failure is a failure to obtain reasonable assurance about whether the financial statements are free of material misstatement. That does not mean that the financial statements are, in fact, materially misstated. Rather, it means that the inspection staff has determined that, because of an identified error or omission, the firm failed to fulfill its fundamental responsibility in the audit – to obtain reasonable assurance about whether the financial statements are free of material misstatement. In other words, investors were relying on an opinion on the financial statements that, when issued, was not supported by sufficient appropriate evidence.

When the Board's inspectors find audit failures, they focus firms on the need for corrective action, which in some cases has resulted in issuers restating previously issued financial statements. The Board also seeks to understand any quality control defects that underlie the audit failures it finds. Through the quality control remediation process,<sup>16/</sup> the Board's findings have led to numerous and significant improvements in firm audit methodologies, processes and related quality control systems.

While the Board believes that both the rigor of inspections and the remediation process have improved audits, it remains concerned about both the frequency and the type of audit deficiencies it continues to find. For example, in a report summarizing the results of its inspections of the largest accounting firms from 2004 through 2007, the Board noted:

Inspectors continue to find deficiencies in important audit areas, both established and emerging. These areas include critical and high-risk parts of audits, such as revenue, fair value, management's estimates, and the determination of materiality and audit scope. These deficiencies occurred in audits of issuers of all sizes, including in some of the larger audits they reviewed. In some

cases, the deficiencies appeared to have been caused, at least in part, by the failure to apply an appropriate level of professional skepticism when conducting audit procedures and evaluating audit results. In addition, even in areas where inspectors have observed general improvement, deficiencies continue to arise.<sup>17/</sup>

In particular, the Board noted that the audits in which inspectors faulted the firms' application of professional skepticism and objectivity included "some of the larger audits inspected."<sup>18/</sup>

These findings have persisted. In congressional testimony earlier this year, the Board's Chairman explained that:

Although the PCAOB's 2010 inspection reporting cycle is not yet complete, so far PCAOB inspectors have continued to identify significant deficiencies related to the valuation of complex financial instruments, inappropriate use of substantive analytical procedures, reliance on entity level controls without adequate evaluation of whether those processes actually function as effective controls, and several other issues. PCAOB inspectors have also identified more issues than in prior years. In any event, the Board is troubled by the volume of significant deficiencies, especially in areas identified in prior inspections. The PCAOB is working on several initiatives to drive improvements in audit quality.<sup>19/</sup>

The Board does not suggest that *all* of the audit failures or other audit deficiencies its inspections staff has detected necessarily resulted from a lack of objectivity or professional skepticism. Audit failures can also reflect a lack of technical competence or experience, which may be exacerbated by staffing pressures or some other problem. And, as the Board's inspections are not random, the Board may be looking at the most error-prone situations. The root causes of audit failures are complex and vary in nature and continue to be explored by the Board. The Board plans to deepen its understanding of root causes in upcoming inspection seasons. At the same time, although the Board attempts to determine root causes, it is not always possible to do so. Because professional skepticism is a state of mind, its absence may be particularly difficult to detect unless evidenced somehow in the audit workpapers or elsewhere.<sup>20/</sup> As the SEC noted in a related context when challenged to demonstrate that the provision of non-audit services had adversely affected audit quality:

... [t]he assertion that no empirical evidence conclusively links audit failures to non-audit services misses the point. ... [T]he subtle influences that we are addressing are, by their nature, difficult to isolate and difficult to link to any particular action or consequence. The asserted lack of evidence isolating those influences and linking

them to questionable audit judgments simply does not prove that an auditor's judgment is unlikely to be affected because of an auditor's economic interest in a non-audit relationship. Indeed, it is precisely because of the inherent difficulty in isolating a link between a questionable influence and a compromised audit that any resolution of this issue must rest on our informed judgment rather than a mathematical certainty.<sup>21/</sup>

As part of one recent inspection, for example, the Board's inspectors found that in making proposals to potential audit clients one of the largest accounting firms used the following phrases, among others:

- Your auditor should be a partner in supporting and helping [the issuer] achieve its goals, while at the same time helping you better manage risk;
- Support the desired outcome where the audit team may be confronted with an issue that merits consultation with our National Office; and
- Stand by the conclusions reached and not second guess our joint decisions.

The Board is concerned that such considerations in the auditor-client relationship may not be just a theoretical problem or a matter of perception. Rather, as a more general phenomenon, this kind of mindset may have affected firms' public company audit work. The Board's inspections frequently find audit deficiencies that may be attributable to a failure to exercise the required professional skepticism and objectivity. Examples in recent large and small firm inspection reports have included:

- [The inspection results] suggest that the audit partners and senior managers [of the inspected firm] may have a bias toward accepting management's perspective, rather than developing an independent view or challenging management's conclusions.
- The inspection results provide cause for concern that the [inspected firm] does not consistently exercise the appropriate degree of professional skepticism in the performance of audits. In a number of engagements, the [firm's] support for significant areas of the audit consisted of management's views or the results of inquiries of management. The lack of professional skepticism appears to stem from the [firm's] culture that allows, or tolerates, audit approaches that do not consistently emphasize the need for an appropriate level of critical analysis and collection of objective evidence.

- Some observations from the engagement reviews suggest that the [inspected firm] is not always sufficiently objective and may not exercise sufficient professional skepticism. This concern results, in part, from instances that the inspection team identified where it appeared that the [firm] may have been too willing to accede to the issuer's desired accounting and from instances where the [firm] accepted information or representations provided by management in significant areas as audit evidence without obtaining corroboration.
- The deficiencies identified by the inspection team suggest that [the inspected firm's] engagement teams may be placing too much reliance on management's responses to the teams' inquiries and not sufficiently challenging or evaluating management's assumptions, and that they may not be applying an appropriate level of professional skepticism in subjective areas susceptible to management bias.
- The inspection team reported that the deficiency may have resulted from a lack of sufficient professional skepticism when evaluating management's plans and the assumptions and assertions underlying management's analyses when estimates requiring judgment are involved. In addition, a more effective review by the engagement leadership might have prevented or detected the deficiency.

Other regulators have found similar problems in other jurisdictions. For example, according to a recent report, the United Kingdom's Audit Inspection Unit found that "[f]irms sometimes approach the audit of highly judgmental balances by seeking to obtain evidence that corroborates rather than challenges the judgments made by their clients."<sup>22/</sup> In reporting on its recent inspections of the Big Four accounting firms, the Netherlands Authority for the Financial Markets stated that it found weaknesses in 29 of the 46 audits it reviewed and identified "insufficient professional scepticism exercised by the external auditor" as one of the causes of these weaknesses.<sup>23/</sup> In Australia, the Securities and Investment Commission stated that its "audit inspection program has identified a number of instances where we have concerns about the auditors' judgement, and the level and attitude of professional scepticism."<sup>24/</sup> The Canadian Public Accountability Board "found several examples of overreliance on management representations" and noted that "[w]hile some reliance on management is inherent in any audit, there is a higher risk of inappropriately reducing professional skepticism in instances where there is greater familiarity or comfort with the reporting issuer and its historical accounting policies and practices."<sup>25/</sup>

While the specific reasons for findings like these are often complex, the Board is concerned they may reflect instances in which the auditors involved failed to put the interests of investors before those of the client's management. This is not to suggest that most auditors are not committed to the principles of auditor independence, objectivity and professional skepticism. In fact, firms spend significant resources on quality control systems and programs to promote them. Nevertheless, even well-intentioned auditors, as with other people, sometimes fail to recognize and guard against their own unconscious biases.<sup>26/</sup>

These are serious problems, and the Board's efforts to address them are ongoing. The Board's inspections and enforcement actions have reinforced how seriously it takes the requirements related to auditor independence. This concept release is intended to explore whether there are other approaches the Board could take that could more consistently focus auditors on the required mindset.

Since the financial scandals that led Congress to adopt the Act, a variety of such approaches have been considered. Some, for example, have proposed to replace the "client payor" model with a system of financial statement insurance. Under such an approach, companies would insure their financial statements against losses suffered by investors. The market would set premiums, which could be made public, and insurance companies would pay for the audit.<sup>27/</sup> Another commentator has explored whether auditors should themselves be converted into the functional equivalent of insurers by subjecting them to stricter, but capped, liability.<sup>28/</sup> Still others have proposed a system of random auditor selection, with, among other things, compensation set by a third party.<sup>29/</sup>

The relative merits of these approaches can and should be debated. Broader approaches of this sort could, however, require legislative changes before they could be implemented. Although this concept release is issued in the context of a broad-based conversation on how auditor independence, objectivity and professional skepticism could be enhanced, the Board is most focused on steps it could take under its existing authority to enhance independence, objectivity and professional skepticism. As stated earlier, the Board seeks input and comment on various approaches it could take to make such enhancements.

As described below, a rotation requirement would aim directly at the basic conflict that, while inherent in the Securities Act of 1933, too often proves difficult for auditors to overcome. By ending a firm's ability to turn each new engagement into a long-term income stream, mandatory firm rotation could fundamentally change the firm's relationship with its audit client and might, as a result, significantly enhance the auditor's ability to serve as an independent gatekeeper.

### **III. Audit Firm Rotation**

The idea of a regulatory limitation on auditor tenure is not new. Over the years, it has been considered by a variety of commentators and organizations. Through this public debate, the basic arguments both for and against mandatory firm rotation have been fairly well described.

#### **A. The Historical Context**

In 1977, in the wake of the Penn Central, Equity Funding, and other corporate scandals, the staff of the Subcommittee on Reports, Accounting, and Management of the Senate Committee on Government Operations, chaired by Sen. Lee Metcalf, published a wide-ranging study of the American "accounting establishment."<sup>30/</sup> In his transmittal letter to Sen. Abraham Ribicoff, Chairman of the full Committee, Sen. Metcalf noted that he was particularly disturbed by "the alarming lack of independence ... shown by the large accounting firms which perform the key function of independently certifying the financial information reported by major corporations to the public."<sup>31/</sup> The study found that "[t]he 'Big Eight' and other large accounting firms readily accepted the special stature associated with their designated role as independent auditors, but they have not fully accepted the special responsibilities which accompany the position of independent auditor."<sup>32/</sup>

The Metcalf Report expressed particular concern over the provision of non-audit services, but also noted that "[l]ong association between a corporation and an accounting firm may lead to such a close identification of the accounting firm with the interests of its client's management that truly independent action by the accounting firm becomes difficult."<sup>33/</sup> In recommending that Congress consider ways to increase competition among accounting firms, the Metcalf Report noted that "one alternative is mandatory change of accountants after a given period of years, or after any finding by the SEC that the accounting firm failed to exercise independent action to protect investors and the public."<sup>34/</sup>

In a report issued the following year, a group that had been established by the American Institute of Certified Public Accountants ("AICPA") reached different conclusions about the need for reform.<sup>35/</sup> The Commission on Auditor's Responsibilities, better known as the Cohen Commission, was formed to "develop conclusions and recommendations regarding the appropriate responsibilities of independent auditors" and consider "whether a gap may exist between what the public expects or needs and what auditors can and should reasonably expect to accomplish."<sup>36/</sup> The Cohen Commission's 1978 report considered "[a] variety of proposals to increase the individual auditor's ability to resist management pressure," including audit firm rotation.<sup>37/</sup>

The Cohen Commission identified two potential benefits of a firm rotation requirement. First, "[s]ince the tenure of the independent auditor would be limited, the auditor's incentive for resisting pressure from management would be increased." Second, "a new independent auditor would bring a fresh viewpoint."<sup>38/</sup>

At the same time, the Cohen Commission expressed concern that "[r]otation would considerably increase the costs of audits because of the frequent duplication of the start-up and learning time necessary to gain familiarity with a company and its operations that is necessary for an effective audit." As a related point, it reported that in its "study of cases of substandard performance by auditors, several of the problem cases were first- or second-year audits," and that, "[w]hile not conclusive, this indicates the higher peril associated with new audit clients." Finally, the Cohen Commission was concerned about "excessive competition between public accounting firms" and believed that rotation would exacerbate this problem by "plac[ing] a larger number of clients 'up for grabs.'"<sup>39/</sup>

Because the Cohen Commission believed that "the cost of mandatory rotation would be high and the benefits that financial statement users might gain would be offset by the loss of benefits that result from a continuing relationship," it recommended against mandatory audit firm rotation.<sup>40/</sup> Instead, the Cohen Commission's view was that the audit committee is in the best position to determine whether rotation is appropriate. The Cohen Commission Report also stated that "[m]any of the asserted advantages of rotation can be achieved if the public accounting firm systematically rotates the personnel assigned to the engagement."<sup>41/</sup>

The SEC staff touched on these issues in 1994, when it included a brief discussion of mandatory firm rotation in a wide-ranging report on auditor independence. The staff report responded to a congressional request for the Commission to study auditor independence and provide any recommendations for legislation or conclusions "regarding changes in the Commission's rules that may be required for the protection of investors or in the public interest."<sup>42/</sup> In its report, the SEC staff indicated its then-current view "that the [profession's] requirement for a periodic change in the engagement partner in charge of the audit, especially when coupled with the [profession's] requirement for second partner reviews, provides a sufficient opportunity for bringing a fresh viewpoint to the audit without creating the significant costs and risks associated with changing accounting firms that were identified by the Cohen Commission."<sup>43/</sup> Ultimately, the report concluded that neither legislation nor "fundamental changes" in the Commission rules were necessary at that time.

In 2002, the Congressional hearings leading up to the enactment of the Act further fleshed out the debate that the Metcalf Report had initiated 25 years earlier. Among other witnesses who testified on the subject, former SEC

Chairmen Arthur Levitt<sup>44/</sup> and Harold Williams<sup>45/</sup> spoke in favor of mandatory firm rotation, while former Chairmen Richard Breeden,<sup>46/</sup> Roderick Hills,<sup>47/</sup> and David Ruder,<sup>48/</sup> and then-Chairman Harvey Pitt<sup>49/</sup> expressed concerns. In the end, although the Act included partner rotation requirements, "[t]he [Senate Banking] Committee determined that the possibility of requiring audit firm rotation merits further study."<sup>50/</sup>

Those testifying in favor of a rotation requirement focused both on strengthening the auditor's ability to resist management pressure and on the benefits of a fresh viewpoint.<sup>51/</sup> In a white paper entered into the legislative record, the Public Oversight Board stated that "[t]he POB agrees with its member, John Biggs, who testified ... that auditor rotation is a 'powerful antidote' to auditor conflicts of interest, which 'reduces dramatically the financial incentives for the audit firms to placate management.'"<sup>52/</sup> The second point—the need for a "fresh viewpoint"—was seen as closely related to the first. Biggs, then Chairman, President, and CEO of TIAA-CREF, testified that an audit firm with less incentive to placate management might exercise that increased independence out of concern about what its replacement might find:

Had Arthur Andersen in 1996 known that Peat Marwick was going to come in in 1997, there would have been a very different kind of relationship between them and Enron. Clearly, they would have wanted to have their work papers in order, all of the deals documented and well explained. They might well have challenged Enron's management in that early period where Enron was changing its accounting. ... I would think that there is a very high probability that had rotation been in place at Enron with Arthur Andersen, you would not have had the accounting scandal that I think we now have....<sup>53/</sup>

Along those lines, Walter Schuetze, former SEC Chief Accountant, testified that if rotation were required every five years or so, "at least the retiring auditor would take his or her Brillo pad and scrub the balance sheet in the third or fourth year and hand over a balance sheet that looked like a new copper penny to the new auditor."<sup>54/</sup> Lynn Turner, former SEC Chief Accountant, testified that these benefits cannot be achieved simply by rotating engagement partners:

One final argument you will hear against the rotation of audit firms is that they already do an internal rotation of audit partners on the companies they audit. ... But once a firm has issued a report on the financial statements of a company, there is an inherent conflict in later concluding that the financial statements were wrong. This is especially true if the company has accessed the capital markets using those financial statements and as a result, that the accounting firm has significant exposure to litigation in the event of

a restatement of the financial statements. By bringing in a new firm every 7 years, you get an independent set of eyes looking at the quality of the financial reporting that have no 'skin in the game' with respect to the previous accounting."<sup>55/</sup>

Those against a rotation requirement testified, primarily, that it would lower audit quality. For example, James Copeland, then CEO of Deloitte & Touche, predicted that a rotation requirement would have negative consequences for investors:

There is strong evidence that requiring the rotation of entire firms is a prescription for audit failure. It would result in the destruction of vast stores of institutional knowledge and guarantee that auditors would be climbing a steep learning curve on a regular basis. It would expose the public to a greater and more frequent risk of audit failure. It would increase the likelihood of undetected fraud by management. It would make it easier for reckless management to mislead the auditor. And finally, it would allow companies to disguise opinion shopping by enabling them to portray a voluntary change in auditors as obligatory."<sup>56/</sup>

Former SEC Chairman Richard Breeden stated that he opposed mandatory rotation because it "in some cases would be a benefit, and in other cases would be a disadvantage." Instead, Breeden recommended "a system where auditors are engaged for a 3 or 4-year period, not for a 1-year period, and that at the end of that time, the audit committee has to go out for proposal and at least hear what the other firms propose ... and then leave it to the audit committee to make a decision on ... whether you should rotate." Breeden also acknowledged that his "idea of having a 3 or 4- year engagement could lend itself to having a statute that said that beyond, say, one initial term and two renewals, that specific standards and findings might have to be made by the audit committee in order to pick the incumbent and keep going."<sup>57/</sup>

Former SEC Chairman Harvey Pitt also offered alternatives to mandatory rotation. Pitt was concerned about, among other things, "the unique strengths particular audit firms bring to the clients in certain industries," and noted that "[l]arge accounting firms are not fungible ... and there can be valid market-driven reasons, such as expertise in a certain industry, for selecting and retaining one firm over others."<sup>58/</sup> In his view, "the answer ... is to establish standards for the audit committee to interview the auditors, to talk to the national partners of the audit firm, find out what steps they are taking to review the quality, and then on top of that, to have every year the [new regulator] come in and do a quality control." Pitt further suggested that if the new regulator "find[s] that audits are not being done at the highest standards, if they think there is sloppiness or slovenliness, give them the power to take away the client."<sup>59/</sup>

In the end, Congress directed the GAO to study and report on "the potential effects of requiring the mandatory rotation of registered public accounting firms."<sup>60/</sup> The Senate Banking Committee noted that some witnesses were in favor of mandatory rotation while others felt that it would be costly and disruptive, and concluded:

While the bill does not require issuers to rotate their accounting firms, the Committee recognizes the strong benefits that accrue for the issuer and its shareholders when a new accountant "with fresh and skeptical eyes" evaluates the issuer periodically. Accordingly, the bill requires a registered public accounting firm to rotate its lead partner and its review partner....<sup>61/</sup>

The GAO's Report was issued in 2003 and was based, in part, on a survey "of public accounting firms and public company chief financial officers and their audit committee chairs of the issues associated with mandatory audit firm rotation."<sup>62/</sup> According to the GAO's survey, 79% of larger audit firms and Fortune 1000 companies that responded believed that changing audit firms increases the risk of an audit failure in the early years of the audit, and most believed that mandatory firm rotation "would not have much effect on the pressures faced by the audit engagement partner."<sup>63/</sup> Nearly all of the larger firms that responded estimated that initial year audit costs would increase by more than 20 percent.<sup>64/</sup>

The GAO also held "discussions with officials of other interested stakeholders, such as institutional investors, federal banking regulators, U.S. stock exchanges, state boards of accountancy, the American Institute of Certified Public Accountants (AICPA), the Securities and Exchange Commission (SEC), and the PCAOB to obtain their views on the issues associated with mandatory audit firm rotation."<sup>65/</sup> The GAO reported that "[g]enerally, the views expressed by these knowledgeable individuals were consistent with the overall views expressed by survey respondents," and that "the majority ... believe[d] that a requirement for mandatory audit firm rotation should not be implemented at this time."<sup>66/</sup> The GAO noted that "[i]ndividuals we spoke with that generally supported mandatory audit firm rotation included representatives of entities that currently have mandatory audit firm rotation policies, a consumer advocacy group, two individuals associated with oversight of the accounting profession, an individual knowledgeable in the regulation of public companies, and an expert in corporate governance."<sup>67/</sup>

As noted above, the report concluded that "mandatory audit firm rotation may not be the most efficient way to enhance auditor independence and audit quality...."<sup>68/</sup> It also stated, however, that "it will take at least several years for the SEC and the PCAOB to gain sufficient experience with the effectiveness of the act in order to adequately evaluate whether further enhancements or revisions,

including mandatory audit firm rotation, may be needed to further protect the public interest and to restore investor confidence."<sup>69/</sup>

Based on its experience conducting inspections, the Board believes that audit quality has improved since the time of the GAO report. Yet, the Board believes that more can be done to bolster auditors' ability and willingness to resist management pressure.

## **B. The Views of the Board's Investor Advisory Group and Others**

On March 16, 2011, at a meeting of the Board's Investor Advisory Group ("IAG"), some members of the IAG (as one of the IAG working groups) urged the Board to consider mandatory firm rotation in the context of lessons learned from the financial crisis. These IAG members stated that "key to concern over independence was the level of 'coziness' the firm had with the management of the company being audited" and noted that "[m]any of the auditors of the large companies involved in the financial crisis ... had long running audit relationships with those companies."<sup>70/</sup> This working group recommended that the Board "undertake a project to establish periodic mandatory rotation of the auditor, for example every ten years."<sup>71/</sup> In supporting its recommendation, the working group stated:

... the purpose of the audit is to provide investors (and audit committee members) confidence that an independent set of eyes have looked at the numbers reported by management and objectively without bias determined they can indeed be relied upon. If investors' confidence in that process is diminished or lost, the benefits of the audit (and its costs) are questioned.<sup>72/</sup>

Questions echoing those raised at the IAG meeting regarding auditor objectivity and independence are being raised not only in the United States but elsewhere as well. As noted above, in late 2010 the European Commission issued a green paper entitled "Audit Policy: Lessons from the Crisis." The EC Green Paper notes the auditor's "societal role in offering an opinion" on companies' financial statements and states:

The independence of auditors should thus be the bedrock of the audit environment. It is time to probe into the true fulfilment of this societal mandate.<sup>73/</sup>

In doing so, the EC Green Paper notes that "the [European] Commission would like to reinforce the independence of auditors and address the conflicts of interest which are inherent to the current landscape characterized by features such as the appointment and remuneration of the auditors by the audited firm, low levels of audit firm rotation or the provision of non audit services by audit

firms.<sup>74/</sup> With respect to rotation, the EC Green Paper states that "[s]ituations where a company has appointed the same audit firm for decades seem incompatible with desirable standards of independence."<sup>75/</sup> Accordingly, the Green Paper recommended that "the mandatory rotation of audit firms—not just of audit partners—should be considered."<sup>76/</sup> Earlier this year, the European Commission made public a summary of the responses received on its Green Paper.<sup>77/</sup>

### **C. Academic Studies**

The Board is also cognizant of the views, described above, of those who do not support mandatory rotation. In particular, views that rotation would have the opposite effect from that intended by the Board warrant very serious consideration. Some commentators have suggested that empirical studies show that fraud is more likely in the early years of an auditor-client relationship. For example, some testified in the 2002 congressional hearings that a 1987 study of financial frauds revealed that "a significant number" of such cases involved companies that had recently changed their auditors.<sup>78/</sup>

There are a number of studies on the relationship between auditor tenure and audit quality.<sup>79/</sup> Many, though not all, tend to support the view that engagements with short tenure are relatively riskier. A limitation of this literature is that studies tend to focus on environments where auditor rotation is voluntary rather than mandatory.<sup>80/</sup> Voluntary rotation may be associated with auditor-issuer disagreements, other financial reporting issues, or economic issues.

The Board's own inspections data has the same limitation. Preliminary analysis of that data appears to show no correlation between auditor tenure and number of comments in PCAOB inspection reports. It is difficult, however, to extrapolate to an environment in which the engagement term would be fixed and assumed by the auditor and client from the outset of every engagement.

A further issue is raised by the Board's risk-based approach. The Board does not select an audit for inspection at random. Rather, it selects the audits that it believes present the highest risks and reviews the areas within each audit that are the most complex and challenging. While such an approach is intended to maximize the Board's efficiency and effectiveness for regulatory purposes, it also introduces selection bias for some research purposes. As the sample of audits inspected is not representative of all audits,<sup>81/</sup> it may not be a suitable basis for drawing conclusions about the relationship between tenure and audit quality, let alone the effects of mandatory rotation on audit quality.

Even in the absence of selection bias, the implications for mandatory rotation of any finding that audit failure is more likely in the early years of an auditor-client relationship are not clear. The reason for such a phenomenon may

be, as some have suggested, that the learning curve is too steep for an auditor to perform a high-quality audit in the early years of a new client engagement. As noted above, though, it might also be because, in the absence of a requirement to change auditors, auditor changes can be associated with financial reporting issues, auditor-client disagreements, or economic issues. Finally, higher failure rates in the early years of an engagement may also reflect a problem that rotation could help address. For example, a new auditor may be particularly focused on establishing a long-term relationship with the client, and therefore less inclined to challenge management. Or, if as some have suggested auditors bid on new engagements with the assumption that they will lose money in the first years of an engagement but recoup that loss over a long period of time, the problem may be unrealistic pricing, with a resulting effect on audit effort or resources at the beginning of an auditor-client relationship.

#### **D. General Questions**

The Board is interested in comment on whether mandatory auditor rotation would significantly enhance auditors' objectivity and ability and willingness to resist management pressure. Does payment by the audit client—inherent in the framework established by Congress in 1933—inevitably create, in the words of the European Commission, "a distortion within the system"?<sup>82/</sup> Is it possible that distortion is amplified when auditors know at the outset of any new engagement that the stream of audit fees they could receive from a new client is unlimited?

If mandatory rotation would not eliminate the distortion—the company under audit would still be paying the fee—could rotation dramatically reduce it? A firm that knows at the outset that it is going to "lose the client" eventually, no matter what it does, might have much less reason to compromise its independence, risking the firm's own reputation and potentially its continued viability, in order to preserve the relationship.<sup>83/</sup>

The Board is also interested in views on whether a periodic "fresh look" at a company's financial statements would enhance auditor independence and protect investors. As has been noted by a number of proponents of mandatory firm rotation, an auditor that knows its work will be scrutinized at some point by a competitor may have an increased incentive to ensure that the audit is done correctly. That, in turn, may decrease an auditor's willingness to accept financial reporting that is not presented in conformity with generally accepted accounting principles.<sup>84/</sup>

Finally, in approaching the following questions, commenters are urged to consider whether alternatives to mandatory rotation exist that would enhance independence, objectivity and professional skepticism. Commenters are also urged to consider whether the current state of the audit profession, in light of engagement partner rotation and audit committee practices following the

passage of the Act, as well as recently promulgated and pending changes to the Board's auditing standards, may have rendered some of the historical perspectives on rotation, summarized above, no longer relevant. The Board is also interested in the evolution of audit committee practices and the increased complexity of the audit as these phenomena may affect the appropriateness of both mandatory firm rotation and other available practices or requirements as means of enhancing auditor independence, objectivity and professional skepticism.

Because the Board believes that the time has come to again explore mandatory auditor rotation, it is soliciting commenters' views on all aspects of the issues discussed in this release. Specific questions on various aspects of a potential rotation requirement are included in the next section. More important, however, at least preliminarily, are commenters' views on the following more general issues:

- 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?
- Would audit firm rotation enhance auditor independence, objectivity and professional skepticism?
- 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?
- 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?
- 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 commenters can provide in this area.

- 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."<sup>85/</sup> 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?
- 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?
- 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?

#### **IV. Possible Approaches to Rulemaking**

If the Board determines to move forward with consideration of a rotation requirement, it could propose a rule providing that a registered public accounting firm is not independent of its audit client if it has provided an opinion on the client's financial statements for a certain number of consecutive years. That approach could be similar in structure to the SEC's rule requiring audit partner rotation.<sup>86/</sup> The Board would need to consider, of course, the appropriate length of the allowed term.

**A. Term of Engagement**

As is evident from the above, various term lengths have been suggested at various times. The length of the term would be a key variable in any proposed rule. A term that is too long might not enhance independence to a sufficient degree to make the rule worthwhile. At the same time, a term that is too short risks increasing costs and causing unnecessary disruption.

A starting point for consideration of an appropriate term is current data on auditor tenure. For the largest 100 companies, based on market capitalization, auditor tenure averages 28 years.<sup>87/</sup> Average tenure for the 500 largest companies is 21 years.<sup>88/</sup> Based on these considerations, the Board is particularly interested in comment on the advantages and disadvantages of terms of 10 years or greater.

Questions:

1. If the Board determined to move forward with development of a rotation proposal, what would be an appropriate term length?
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?
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?
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.<sup>89/</sup> 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?
5. How much time should be required before a rotated firm could return to an engagement?

## **B. Scope of Potential Requirement**

Another fundamental decision is whether to consider a rotation requirement for all audits conducted pursuant to PCAOB standards or whether to limit the audits to which the requirement would apply. For example, the Board could consider applying the rule only to audits of the largest companies. Such an approach could minimize the costs of the rule, while preserving much of its benefits. On the one hand, it could reduce market-wide implementation costs because the vast majority of companies and firms would not be affected. On the other hand, by focusing only on companies with the largest market capitalization, could the Board obtain significant benefits for investors?

### Question:

6. Should the Board consider requiring rotation for all issuer audits or just for some subset, such as audits of large issuers?<sup>90/</sup> 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?

## **C. Transition and Implementation Considerations**

Any rotation rule would also need to be considered in light of the fact that for many companies, particularly large, multinational ones, there may be a practical limit to the number of audit firms to choose from. Even among the larger firms, different firms may have different capacities and areas of expertise. Independence rules restricting the kinds of non-audit services a firm may provide its audit client might further limit a company's choice of auditor. For example, a large company might employ one large firm as its auditor and another (or more than one other) to provide various non-audit services that its auditor is prohibited from providing. If rotation were required, the company's choice of a new auditor might be limited unless it terminated existing prohibited non-audit services, which it might not be able to do in a timely manner.

Considered from another perspective, however, rotation could "operate as a catalyst to introduce more dynamism and capacity into the audit market."<sup>91/</sup> That is, if the largest firms were periodically displaced from their positions auditing the largest companies, more firms might develop additional capacity and expertise in order to compete for those engagements. If so, auditor choice would be increased. It is also at least possible that some firms would develop "audit-only" practices so that prohibited non-audit services would never interfere with their ability to compete for new audit engagements, which would become available much more frequently if rotation were required. On the other hand, independence could suffer if firms—knowing that their audit engagement is about

to come to an end—begin to focus on marketing future non-audit services to the audit client.

The Board's purpose in adopting any rotation requirement would be to enhance auditor independence, objectivity and professional skepticism, a goal directly in line with the Board's statutory mission "to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports."<sup>92/</sup> If a consequence of a rotation requirement were an increase in the number of firms capable of auditing, and willing to audit, the largest public companies, however, that may benefit investors and, more generally, the financial markets.

Questions:

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?
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?
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?
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?
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.<sup>93/</sup> 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.<sup>94/</sup> 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?

If the Board determined to move forward with development of a rotation proposal, it would also need to consider whether a rotation requirement should be accompanied by any 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, the Board could consider additional quality control or other procedures to mitigate that risk. Such procedures could include, for example, heightened internal supervision or oversight requirements for the first year or two of a new engagement, increased required communications between predecessor and successor auditors or other steps auditors could be required to take during the transition from one firm to another.

The Board is also interested in the view expressed by some that audit committees should be prohibited from removing the auditor without good cause prior to the end of the allowable term. Some measure of tenure protection during the term might further bolster the auditor's ability to resist management pressure. The Board invites commenters' opinions on the advantages and disadvantages of such a limitation and how it might be imposed.

Because implementation of some aspects of a rotation requirement could involve complementary changes to SEC rules, development of any rotation rule could require particularly close coordination with the SEC.<sup>95/</sup> The Board would also need to consider how to transition toward any requirement in this area. For example, if the Board determined to move forward, it could stagger a new requirement's effective date to avoid mass rotation in a single year.

Questions:

16. Are there any requirements the Board should consider to mitigate any risks posed by rotation? For example, are there enhancements to firms' quality control systems that might address such risks?
17. If the early years of an auditor-client relationship pose higher audit risks than later years, should the Board require firms to provide additional audit supervision and oversight in the first year or two of a new engagement? Should the Board impose such a requirement for auditor changes even if it does not further consider requiring audit firm rotation? If firms are accepting new clients but are unable to perform quality audits for them until several years have passed, should the Board require enhanced client acceptance procedures? What impact would additional requirements of this type have on audit costs?
18. If mandatory rotation were required, are existing standards relating to communications between predecessor and successor auditors sufficient? Should additional communications be required? For example, should the outgoing auditor provide the incoming auditor with a written report outlining audit risks and other important information about the company?
19. Are there other audit procedures that should be required to mitigate any risks posed by rotation?
20. If the Board moved forward with development of a rotation proposal, should consideration be given to the recommendation for a cause restriction on the company's ability to remove an auditor before the end of a fixed term? Would such a provision be useful? Would there be unintended consequences of such a requirement? Should the Board work with the SEC on implementation of this recommendation? Are there other matters on which the Board should coordinate with the SEC?
21. What other transition issues might arise in the first year of a rotation requirement? How should the Board address these issues?

**V. Opportunity for Public Comment**

The Board will seek comment for a 120-day period. Interested persons are encouraged to submit their views to the Board. Written comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by e-mail to

comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 37 in the subject or reference line and should be received by the Board no later than 5:00 PM EST on December 14, 2011. The Board will consider all comments received.

The Board will also convene a roundtable meeting in March 2012, at which interested persons will present their views on independence and mandatory firm rotation. Additional details about the roundtable will be announced at a later date.

On the 16th day of August, in the year 2011, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour  
Secretary

August 16, 2011

---

<sup>1/</sup> See, e.g., SEC, Relationships Between Registrants and Independent Accountants, ASR 296 (1981) (stating that "[i]ndependence is the essential attribute of the auditor because, absent independence, the auditor's skills and services are of little value"); *U.S. v. Arthur Young & Co.*, 465 U.S. 805, 819-820 n. 15 (1984) (noting that "[i]f investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might well be lost").

<sup>2/</sup> While the terms "independence," "objectivity," and "professional skepticism" have slightly different connotations, they all relate to the auditor's ability to perform the audit in a disinterested manner, free from influence by the client. An independent auditor is more likely to exercise appropriate professional skepticism and make objective auditing judgments.

<sup>3/</sup> U.S. General Accounting Office, Required Study on the Potential Effects of Mandatory Audit Firm Rotation 8 (2003) ("GAO Report").

<sup>4/</sup> *Id.* at 5, 8.

---

<sup>5/</sup> For example, in October 2010, the European Commission issued a "Green Paper" on "the role of the audit as well as the scope of the audit ... in the general context of financial market regulatory reform." Among other things, the paper discusses possible ways to "reinforce the independence of auditors and address the conflicts of interest which are inherent to the current landscape...." European Commission, *Audit Policy: Lessons from the Crisis* 3, 11 (2010) ("EC Green Paper"); see also U.K. House of Lords, Select Committee on Economic Affairs, *Auditors: Market Concentration and Their Role* (2011); U.K. Financial Reporting Council, *Effective Company Stewardship: Enhancing Corporate Reporting and Audit* (2011).

<sup>6/</sup> For a revealing colloquy of the consideration of the independence issue in the context of the passage of the Securities Act of 1933 ("1933 Act"), see Appendix A.

<sup>7/</sup> *U.S. v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984) (emphasis in original).

<sup>8/</sup> Rule 2-01(b) of Regulation S-X, 17 C.F.R. § 210.2-01(b), provides that the SEC "will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment...." Thus, not only must the auditor approach his or her work with the appropriate mindset (independence in fact), but also refrain from activities or relationships that would lead a reasonable investor to conclude that his or her independence is impaired (independence in appearance). In doing so, the auditor must also, of course, comply with all specific independence requirements.

<sup>9/</sup> Paragraph .02 of AU sec. 150, *Generally Accepted Auditing Standards*.

<sup>10/</sup> Paragraph .07 of AU sec. 230, *Due Professional Care in the Performance of Work*.

<sup>11/</sup> AU sec. 230.09; see also paragraph .13 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit* (requiring the auditor to "conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity").

<sup>12/</sup> See, e.g., Title II of the Act; Rule 2-01 of Regulation S-X; PCAOB Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles*.

---

<sup>13/</sup> In proposing to prohibit a company's auditor from also providing certain non-audit services, for example, the SEC noted:

Payment of fees by the company to the auditor for performance of the audit and issuance of the auditor's opinion on the company's financial statements often is cited as a fundamental issue in the area of auditor independence. This fee structure was inherent in the decision by Congress in 1933 to have private sector auditors, rather than government employees, audit public companies. Rather than being a reason for liberalization of the independence regulations, this payment structure should be a cause for exercising greater care by both companies and auditors in maintaining the auditor's independence.

Revision of the Commission's Auditor Independence Requirements, Exchange Act Rel. No. 42994, at n.18 (June 30, 2000) (internal citation omitted).

<sup>14/</sup> See Revision of the Commission's Auditor Independence Requirements, Exchange Act Rel. No. 43602 (Nov. 21, 2000); see also Section 201 of the Act.

<sup>15/</sup> See, e.g., S. Sugawara, *Accounting Rule in the Balance; Levitt Lobbying to Save Proposed Curbs on Firms' Consulting Work*, Wash. Post, Oct. 24, 2000, at E1 (describing SEC Chairman's efforts "to protect an SEC proposal that would ban accounting firms from offering consulting services to their audit clients" in the face of "a firestorm of protests from many accountants, led by the American Institute of Certified Public Accountants"); see also Z. Palmrose and R. Saul, *The Push for Auditor Independence*, Regulation: The Cato Review of Business and Government, 18-23, Winter 2001 (concluding that "[t]he SEC's [2000] rulemaking on auditor independence should be viewed as a failure of the regulatory process" because "in the absence of strong empirical evidence, accounting firms should be free to establish their own models for organizing themselves" and claiming that "[b]ecause the evidence to justify a new independence rule was rather weak, the SEC resorted to questionable tactics to achieve its ends").

<sup>16/</sup> The Act affords inspected firms one year within which to remediate Board criticisms concerning firm quality controls. If the Board is not satisfied with a firm's remediation efforts, the otherwise non-public portion of the report containing the discussion of the quality control deficiencies becomes public, subject to review by the Commission.

---

<sup>17/</sup> Report on the PCAOB's 2004, 2005, 2006, and 2007 Inspections of Domestic Annually Inspected Firms, PCAOB Rel. No. 2008-008, at 2 (Dec. 5, 2008).

<sup>18/</sup> *Id.* at 20.

<sup>19/</sup> *Hearing on the Role of the Accounting Profession in Preventing Another Financial Crisis Before the S. Comm. on Banking, Housing, and Urban Affairs, Subcomm. on Securities, Insurance, and Investment, 112<sup>th</sup> Cong.* (2011) (statement of James R. Doty, Chairman, PCAOB), available at <http://pcaobus.org/News/Speech/Pages/default.aspx>.

<sup>20/</sup> *Cf.* Max H. Bazerman, George Loewenstein and Don A. Moore, Why Good Accountants Do Bad Audits, *Harvard Bus. Rev.* 80 (11) (2002) ("Bias, by its very nature is typically invisible: You can't review a corporate audit and pick out errors attributable to bias.").

<sup>21/</sup> Revision of the Commission's Auditor Independence Requirements, *supra* note 14.

<sup>22/</sup> See U.K. Audit Inspection Unit, 2009/10 Annual Report 4 (July 21, 2010) (stating that "[a]uditors should exercise greater professional scepticism particularly when reviewing management's judgments relating to fair values and the impairment of goodwill and other intangibles and future cash flows relevant to the consideration of going concern"); see also U.K. Financial Reporting Council, *Effective Company Stewardship: Enhancing Corporate Reporting and Audit* 14 (2011) (stating that "[t]he FRC is particularly keen to ensure that the right environment is created for increased auditor scepticism when assessing material assumptions and estimates"). In its most recent annual report, the U.K. Audit Inspection Unit noted that its "findings continue to identify the need for firms to ensure that both partners and staff exercise appropriate professional scepticism, particularly in respect of key areas of audit judgment such as the valuation of assets and the impairment of goodwill and other intangible assets." U.K. Audit Inspection Unit, 2010/11 Annual Report 6 (July 19, 2011).

<sup>23/</sup> Netherlands Authority for the Financial Markets, Report on General Findings Regarding Audit Quality and Quality Control Monitoring 10 (Sept. 1, 2010).

<sup>24/</sup> Australian Securities & Investments Commission, Audit Inspection Program Public Report 2009-10 13-14 (June 2011).

---

<sup>25/</sup> Canadian Public Accountability Board, *Enhancing Audit Quality: Report on the 2010 Inspections of the Quality of Audits Conducted by Public Accounting Firms 11* (April 2011).

<sup>26/</sup> See, e.g., Bazerman et al., *supra* note 20 (suggesting that while "deliberate corruption" accounts for some audit problems, "[t]he deeper, more pernicious problem with corporate auditing, as it's currently practiced, is its vulnerability to unconscious bias," and recommending mandatory firm rotation with "fixed, limited contract periods during which [the auditor] cannot be terminated").

<sup>27/</sup> See, e.g., Joshua Ronen, *Post-Enron Reform: Financial Statement Insurance, and GAAP Re-visited*, 8 *Stanford Journal of Law, Business & Finance* 39, 48 (2002) (concluding that "no exogenous force—legislation, regulation, enforcement, or litigation—can satisfactorily resolve the intractable conflict of interest" created by the client payor model, and arguing that "[w]e need to create instead an agency relationship between the auditor and an appropriate principal—one whose economic interests are aligned with those of investors, who are the ultimate intended beneficiaries of the auditor's attestation"). Of course, Section 301 of the Act, which, for listed companies, makes the audit committee responsible for the appointment, compensation, and oversight of the auditor, can be viewed as a step towards making the auditor accountable to a more "appropriate principal." Although an improvement in the view of some, others argue that that requirement does not fundamentally alter the client payor model and has not prevented the kinds of problems described above. See David Kahn and Gary Lawson, *Who's the Boss?: Controlling Auditor Incentives Through Random Selection*, 53 *Emory Law Journal* 391, 409 (2004) (arguing that "[t]he audit committee does not come close to solving the basic incentive problems inherent in the current audit system").

<sup>28/</sup> John Coffee, *Gatekeeper Failure And Reform: The Challenge Of Fashioning Relevant Reforms*, 84 *Boston University Law Review* 301, 349-53 (2004).

<sup>29/</sup> See Kahn & Lawson, *supra* note 27, at 414-15. Similarly, at one point during Congress's consideration of the Act, U.S. Rep. Richard Baker, then Chairman of the House Subcommittee on Capital Markets, questioned whether it would be feasible to have stock exchanges hire and pay the auditor, Ronald Brownstein, *Post-Enron, Congress Must Reassure Investors*, *L.A. Times*, Feb. 11, 2002, at A13. On this point, Chairman Baker said "After all, should we really be surprised when you pay the piper, the piper plays your tune?" See *Hearings on the Enron Collapse: Implications to Investors and the Capital Markets Before the H. Comm. On Financial Services, Subcomm. On Capital Markets, Insurance, and Government Sponsored Enterprises*, 107<sup>th</sup> Cong., Part 2 15 (2002).

---

<sup>30/</sup> Staff of Subcomm. on Reports, Accounting and Management of the S. Comm. on Government Operations, 95<sup>th</sup> Cong., The Accounting Establishment iii (Comm. Print 1977) ("Metcalf Report").

<sup>31/</sup> *Id.* at v.

<sup>32/</sup> *Id.* at 50.

<sup>33/</sup> *Id.* at 21.

<sup>34/</sup> *Id.* at 21. The other alternative mentioned by the report was "amendment of the Federal securities laws to require that more than one accounting firm be on the ballot at annual meetings of stockholders." *Id.*

<sup>35/</sup> The Metcalf Report noted that this group was "comprised entirely of representatives from large accounting firms, large law firms, large investment firms, large corporations, and academic accountants, some of whom have ties to the 'Big Eight' accounting firms." Metcalf Report at 119.

<sup>36/</sup> The Commission on Auditors' Responsibilities, Report, Conclusions, and Recommendations xi (1978) ("Cohen Commission Report"). The Commission's Chairman was Manuel F. Cohen, then a partner at Wilmer, Cutler, and Pickering and a former Chairman of the SEC.

<sup>37/</sup> *Id.* at 105. Among the other proposals the Cohen Commission considered in this area was "to have independent auditors approved, assigned, or compensated by a government agency or to have audits conducted by a corps of government auditors." After noting that "[a]rrangements such as these were specifically rejected when the federal securities acts were adopted," the Cohen Commission concluded:

... the Commission has not identified any areas in which further regulation of the public accounting profession by government would be warranted either by the magnitude of deficiencies in present practice or by promise of future improvements. The same arguments apply to proposals to have auditors approved, assigned, or compensated by the government. Therefore ... we do not consider structural changes of this nature to be necessary or warranted.

*Id.*

<sup>38/</sup> *Id.* at 108.

---

<sup>39/</sup> *Id.* at 108-09. *But see* Metcalf Report at 21 (recommending increasing competition among accounting firms and suggesting rotation as a means of doing so); EC Green Paper at 16 (stating that not only might mandatory rotation increase auditor independence, it could also "operate as a catalyst to introduce more dynamism and capacity into the audit market"); U.K. House of Lords, Economic Affairs Committee, Auditors: Market Concentration and their Role, paragraph 44 (2011) (finding that "[t]he very long tenure of auditors at large companies is evidence of the lack of competition" and recommending "that FTSE 350 companies carry out a mandatory tender of their audit contract every 5 years").

<sup>40/</sup> Cohen Commission Report at 109.

<sup>41/</sup> *Id.*

<sup>42/</sup> SEC, Office of the Chief Accountant, Staff Report on Auditor Independence 1 (1994).

<sup>43/</sup> *Id.* at 54.

<sup>44/</sup> *See Accounting Reform and Investor Protection Issues Raised by Enron and Other Companies: Hearings Before the S. Comm. on Banking, Housing and Urban Affairs, 107<sup>th</sup> Cong. 15 (2002) (hereinafter "Senate Sarbanes-Oxley Hearings").*

<sup>45/</sup> Former Chairman Williams testified that he believed that rotation would increase audit costs and "also involve the inefficiency of the learning curve for the new auditor," but stated that he "view[ed] all of these potential costs as acceptable if it reinforces the auditor's independence and makes the work more comprehensive." *See* Senate Sarbanes-Oxley Hearings at 24, 51, 76. In addition, along with former Comptroller General Charles Bowsher, former Chairman Williams also testified that the client should not be able to terminate the auditor without cause before the end of a fixed term. *Id.* at 24, 900.

<sup>46/</sup> *Id.* at 17, 52, 65.

<sup>47/</sup> *Id.* at 84.

<sup>48/</sup> *Id.* at 52, 71.

<sup>49/</sup> *Id.* at 1079, 1122.

<sup>50/</sup> S. Rep. No. 107-205, at 21 (2002).

---

<sup>51/</sup> With respect to the first point, Damon Silvers, Associate General Counsel of the AFL-CIO, testified about the "confluence of forces that are at work to compromise the audit," and said that "one of the most important is this sense of cash flows in perpetuity that come from keeping a client happy, and the way in which there is a kind of melding of the audit firm and the staff of the people they are auditing." *The Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002: Hearing on H.R. 3763 Before the H. Comm. on Financial Services*, 107<sup>th</sup> Cong. 163 (2002) (hereinafter "House Sarbanes-Oxley Hearings"); see also Association of Chartered Certified Accountants, *Audit Under Fire: A Review of the Post-Financial Crisis Inquiries 7* (2011) (stating that it "does not agree with mandatory rotation of firms," but noting that "it is hard to argue that a firm can be external auditor to a company for 30 years without becoming part of the 'organogram' of the company").

<sup>52/</sup> Senate Sarbanes-Oxley Hearings at 990. In his testimony before the Senate Banking Committee, Biggs stated that TIAA-CREF has a policy of rotating its auditor every seven years, and that the experience "is not nearly as bad as many would make it out to be." More recently, at a meeting of the Board's Investor Advisory Group, Anne Simpson, Senior Portfolio Manager, Global Equity, at the California Public Employees' Retirement System, noted that "CalPERS is huge. ... [b]ut it is required by law locally to rotate its auditors every five years and is not allowed to reappoint the existing firm." See comments of Anne Simpson, Investor Advisory Group Meeting (May 4, 2010), available at [http://pcaobus.org/News/Webcasts/Pages/05042010\\_IAGMeeting.aspx](http://pcaobus.org/News/Webcasts/Pages/05042010_IAGMeeting.aspx).

<sup>53/</sup> Senate Sarbanes-Oxley Hearings at 347-48. Similarly, Abraham Briloff, a professor emeritus at Bernard Baruch College, testified:

And that brings to mind an observation made by Jack Seidman, one of the profession's greats, who made it probably 35, 40 years ago, who referred to the fact that Mrs. Seidman was a most meticulous housekeeper. But he said, when she expects company to be coming, she is especially so. The house is even more effectively kept. So it is that if a firm expects they will be superseded 2 or 3 years down the line, they try as much as they can to make sure they are leaving with a clean slate.

*Id.* at 715.

<sup>54/</sup> Senate Sarbanes-Oxley Hearings at 220.

<sup>55/</sup> *Id.* at 249.

---

<sup>56/</sup> *Id.* at 821. Barry Melancon, President and CEO of the AICPA, similarly testified:

Mandatory rotation of audit firms has been proven to increase the potential for fraud. ... When you look at an audit engagement, there is a team of people, these are multi-national companies in large part today, there are literally hundreds and hundreds of people involved in learning curves and understanding the business complexities. To rotate that whole team of people actually creates a greater risk from an audit quality perspective.

House Sarbanes-Oxley Hearings at 11, 23.

<sup>57/</sup> House Sarbanes-Oxley Hearings at 165, 170.

<sup>58/</sup> Senate Sarbanes-Oxley Hearings at 1122.

<sup>59/</sup> *Id.* at 1079.

<sup>60/</sup> Section 207 of the Act.

<sup>61/</sup> S. Rep. 107-205, at 21.

<sup>62/</sup> GAO Report at 2.

<sup>63/</sup> *Id.* at 6.

<sup>64/</sup> *Id.*

<sup>65/</sup> *Id.* at 2-3.

<sup>66/</sup> *Id.* at 40, 43.

<sup>67/</sup> *Id.* at 43 n.46. The GAO Report also noted that "SEC and PCAOB officials informed us that they have not taken a position on the merits of mandatory audit firm rotation." *Id.* at 40 n.45.

<sup>68/</sup> *Id.* at 2-4.

<sup>69/</sup> GAO Report at 8.

<sup>70/</sup> Memorandum by the IAG Subcommittee on Global Networks and Audit Firm Governance 6, available at [http://pcaobus.org/News/Events/Pages/03162011\\_IAGMeeting.aspx](http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx). Another IAG working group stated that "serious questions have been raised both about

---

the quality of these financial institutions' financial reporting practices and about the quality of audits that permitted those reporting practices to go unchecked." These IAG members questioned whether the audits of these financial institutions were conducted with sufficient professional skepticism, Report from the Working Group on: Lessons Learned from the Financial Crisis, "The Watchdog That Didn't Bark ... Again," 4 (Mar. 16, 2011), available at [http://pcaobus.org/News/Events/Pages/03162011\\_IAGMeeting.aspx](http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx).

<sup>71/</sup> Memorandum by the IAG Subcommittee on Global Networks and Audit Firm Governance, at 12. The group also recommended "that any rules adopted permit the auditor to be removed only for cause, as defined by the PCAOB." *Id.* at 13.

<sup>72/</sup> Memorandum by the IAG Subcommittee on Global Networks and Audit Firm Governance, at 8. Similarly, at another IAG meeting, Meredith Williams, Executive Director of the Colorado Public Employment Retirement Association, while acknowledging that rotation would increase costs, stated that:

... I think there's huge, huge value in having a rotation of those different perspectives. It is a huge value to the auditee, whether it is me as a pension plan, whether it is someone else as a corporate entity.

See Comments of Meredith Williams, IAG Meeting (May 4, 2010), available at [http://pcaobus.org/News/Webcasts/Pages/05042010\\_IAGMeeting.aspx](http://pcaobus.org/News/Webcasts/Pages/05042010_IAGMeeting.aspx).

<sup>73/</sup> EC Green Paper at 3. The EC Green Paper, is available at [http://ec.europa.eu/internal\\_market/consultations/2010/green\\_paper\\_audit\\_en.htm](http://ec.europa.eu/internal_market/consultations/2010/green_paper_audit_en.htm).

<sup>74/</sup> *Id.* at 11.

<sup>75/</sup> *Id.* On May 30, 2011, the Committee on Legal Affairs of the European Parliament commented on the EC Green Paper by issuing a non-legislative report with a proposed motion for a European Parliament Resolution. The Committee stated that it:

[a]grees that the independence of the auditor is of paramount importance and that steps need to be taken to prevent excessive familiarity; suggests that the Commission should undertake an impact assessment covering a range of options, in particular external rotation and the impact of voluntary joint audits; regards external rotation as a means of strengthening the independence of auditors, but reiterates its view that it is not external rotation but

---

rather regular changes in [engagement partners] which represents the best regulatory solution, as confirmed by Directive 2006/43/EC, and that the existing partner rotation arrangements provide the independence necessary for audits to be effective.

Committee on Legal Affairs, European Parliament, Report on Audit Policy: Lessons from the Crisis 7 (2011/2037(INI)). The European Commission has sole authority to initiate the European Union's ordinary legislative procedures in this area by proposing legislation which then goes to the Parliament and the European Council for consideration. On July 1, 2011, Michel Barnier, Commission of Internal Market and Services for the European Commission, expressed interest in an audit firm rotation requirement in a speech to the Federation of European Accountants.

<sup>76/</sup> EC Green Paper at 11. The EC Green Paper also discusses a number of other possible reforms. For example, noting that payment by the audit client "creates a distortion within the system," the paper states that the EC is considering a framework "wherein the appointment, remuneration and duration of the engagement would be the responsibility of a third party...." *Id.* The paper also suggests that "[a] limit to the proportion of fees an audit firm can receive from a single audit client compared to the total revenues of the firm could be envisaged along with appropriate disclosures." *Id.* at 12 (internal citation omitted). "Another aspect that should be considered," according to the EC Green Paper, "is how to achieve more transparency with regard to the audit firm's own financial statements." *Id.*

<sup>77/</sup> See [http://ec.europa.eu/internal\\_market/consultations/2010/green\\_paper\\_audit\\_en.htm](http://ec.europa.eu/internal_market/consultations/2010/green_paper_audit_en.htm).

<sup>78/</sup> See Senate Sarbanes-Oxley Hearings at 725 (statement of Shaun O'Malley, Chairman, 2000 Public Oversight Board Panel on Audit Effectiveness and former Chairman, Price Waterhouse), *citing* Report of the National Commission on Fraudulent Financial Reporting (1987) ("Treadway Commission Report"). That report found, however, that such companies replaced their auditors "often because of disagreements over accounting policies," which may raise a question about whether the frauds began during the tenure of the replaced auditor or the replacement. See Treadway Commission Report at 54 (1987). Two subsequent updates of the report in 1999 and 2010 also noted similar findings, but the 2010 report concluded that "[m]ore research is needed to fully understand the relation between auditor change and fraudulent financial reporting." See Fraudulent Financial Reporting 1998-2007 45 (2010); Fraudulent Financial Reporting: 1987-1997 7 (1999).

---

Others who testified in the 2002 hearings disputed the relevance of such studies. For example, former Comptroller General Charles Bowsher noted that there are:

some studies that kind of indicate maybe among the smaller audits that [the risk of audit failure is higher in the first year]. But when you look at the big audit failures of recent years, hardly any of them have ever been in the first year. In other words, if there is anything, it is that some corporations have been audited by the same firm for 15, 20, or 30 years.

Senate Sarbanes-Oxley Hearings at 915; see also *id.* at 198 (statement of Lynn Turner) (stating "that investors have suffered their largest losses on audits of companies that did not involve an initial audit, but rather an ongoing relationship" and citing Enron, MicroStrategy, Xerox, Waste Management, and others).

<sup>79/</sup> See, e.g., D. Li, Does auditor tenure affect accounting conservatism? Further evidence, *Journal of Accounting and Public Policy* 29, 226-241 (2010); L. Davis, B. Soo. and G. Trompeter, Auditor Tenure and the Ability to Meet or Beat Earnings Forecasts, *Contemporary Accounting Research* 26 (2), 517-548 (2009); M. Cameran, A. Prencipe, and M. Trombetta, Auditor Tenure and Auditor Change: Does Mandatory Rotation Really Improve Audit Quality?, *Proceedings of the Annual Meeting and Conference on Teaching and Learning in Accounting*, New York 1-61 (2008); J. Carcello and A. L. Nagy, Audit Firm Tenure and Fraudulent Financial Reporting, *Auditing: A Journal of Practice & Theory* 23 (2), 55-69 (2004); N. George, Auditor Rotation and the Quality of Audits, *The CPA Journal* 74 (12), 22-26 (Dec 2004); M.A. Geiger and K. Raghunandan, Auditor Tenure and Audit Reporting Failures, *Auditing: A Journal of Practice & Theory* 21 (2), 67-78 (2002); A. Ghosh and D. C. Moon, Auditor Tenure and Perceptions of Audit Quality, *The Accounting Review* 80 (2), 585-612 (2005); E. Johnson, I. K. Khurana, and J. K. Reynolds, Audit-Firm Tenure and the Quality of Financial Reports, *Contemporary Accounting Research* 19 (4), 637-660 (2002); B. Kealey, H. Lee and M. Stein, The Association Between Audit-Firm Tenure and Audit Fees Paid to Successor Auditors: Evidence from Arthur Andersen, *Auditing: A Journal of Practice & Theory* 26 (2), 95-116 (2007); J. Myers, L. Myers, and T. Omer, Exploring the Term of the Auditor-Client Relationship and the Quality of Earnings: A Case for Mandatory Auditor Rotation?, *The Accounting Review* 78 (3), 779-799 (2003).

<sup>80/</sup> An exception is a working paper that focuses on Italy, where mandatory rotation has been in place for more than two decades. Cameran et al., *supra* note 79. The authors found that audit quality tends to improve with tenure. To measure audit quality, the authors focused on abnormal accruals, because,

---

according to the authors, "high-quality audits should mitigate more extreme management reporting decisions," and "[a]ccruals can be used to identify these extreme reporting decisions." *Id.* at 10. Information gathered through the Board's oversight activities indicates that abnormal accruals do not appear to be a good measure of audit quality. Specifically, PCAOB staff have found no direct statistical relationship between the size of an abnormal accrual and the probability that inspections staff would detect an audit failure.

Other countries have, at various times, required some form of mandatory audit firm rotation. As one example, Spain adopted mandatory rotation in 1988 and repealed it in 1995. During the GAO's study of mandatory rotation, the Director of the Comision Nacional del Mercasos de Valores, the Spanish securities regulator, "indicated that the ... rotation requirement was abandoned since the main objective of increased competition among audit firms had been achieved and because of listed companies' increased training costs incurred with a complete new team of auditors from a new public accounting firm." GAO Report at 86. According to others, the requirement was repealed in response to pressure from the Spanish auditing profession. See N. Gomez Aguilar, N. Carrera, E. Barbadillo, and C. Humphrey, *Mandatory Audit Firm Rotation in Spain: A Policy That was Never Applied* 1,12 (working paper) (2006).

Other studies have focused on the crisis-driven rotation that occurred due to the series of events that led to Arthur Andersen's criminal indictment and subsequent demise. See, e.g., Kealey et al., *supra* note 79. A crisis-driven rotation differs from a fixed-term rotation because neither the auditor nor the client know from the outset of the relationship that the auditor's tenure will be limited.

<sup>81/</sup> See, e.g., Report on the PCAOB's 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms, PCAOB Release No. 2007-010 (Oct. 22, 2007) ("the selection of audits for review was not, and was not intended to be, a representative sample of the audits that the firms performed," and "a review of an audit generally encompasses only certain aspects of the firm's performance of that audit, which aspects were selected based on perceived risk and other factors"). In addition, each inspection report the PCAOB issues on an annually inspected firm contains a prefatory note that states, in part:

[T]he Board cautions against drawing conclusions about the comparative merits of the annually inspected firms based on the number of reported deficiencies in any given year. The total number of audits reviewed is a small portion of the total audits performed by these firms, and the frequency of deficiencies identified does not necessarily represent the frequency of deficiencies throughout the firm's practice. Moreover, if the Board discovers a potential

---

weakness during an inspection, the Board may revise its inspection plan to target additional audits that may be affected by that weakness, and this may increase the number of deficiencies reported for that firm in that year. Such weaknesses may emerge in varying degrees at different firms in different years.

<sup>82/</sup> See EC Green Paper at 11.

<sup>83/</sup> While the incentives to maintain good relations with clients may change as auditor tenure increases, they are present even in the first year of a new engagement. At the beginning, there may be pressure to build a long-term relationship. As tenure increases, there may be pressure not to lose a long-standing client. Both pressure to obtain and pressure to retain can compromise auditor independence.

<sup>84/</sup> While the Board's inspection program provides an objective assessment of those audits that the Board's inspectors select for review, it is not intended, and cannot reasonably be expected, to provide the kind of fresh look at a company's financial statements that auditor rotation would provide. Aside from the fact that an inspection is focused on the audit, not the financial statements themselves, the Board can only review a sample of a particular firm's audit engagements due to resource constraints.

<sup>85/</sup> The Conference Board, Commission on Public Trust and Private Enterprise, Findings and Recommendations 39 (2003).

<sup>86/</sup> Rule 2-01(c)(6) of Regulation S-X, 17 C.F.R. § 210.2-01(c)(6).

<sup>87/</sup> Twenty of these companies have used the same auditor for 50 years or longer.

<sup>88/</sup> Average tenure would, presumably, be longer if clients of Arthur Andersen had not been forced to engage new auditors in 2002.

<sup>89/</sup> For example, former SEC Chairman Pitt testified:

So if you think about it this way, let's say I am an auditor and I am going to assume the worst about auditors now, even though I do not as a practical proposition. In my first 2 years, I am not smart enough to know where all the problems are. And in my last year or two, I know I am losing this client, so I do not really care, even if I am now smart. Now if you have a 5 year rotation, you have knocked off four-fifths of the period.

---

Senate Sarbanes-Oxley Hearings at 1079.

<sup>90/</sup> The Board is not, at this time, considering or seeking comment on a rotation requirement for audits of non-issuer brokers and dealers.

<sup>91/</sup> EC Green Paper at 16; see *also* Metcalf Report at 21.

<sup>92/</sup> Section 101 of the Act.

<sup>93/</sup> See, *e.g.*, Senate Sarbanes-Oxley Hearings at 1122 (statement of Harvey Pitt).

<sup>94/</sup> See Institute of Chartered Accountants in England and Wales, *Mandatory Rotation of Audit Firms 13* (2002) (noting, without accepting, argument that mandatory rotation prevents opinion shopping because "auditors would have less incentive to accept inappropriate views and ... management will not be able to select and stick with the one auditor who is willing to relax their objectivity").

<sup>95/</sup> Any rotation rule would, of course, need to be approved by the SEC before it could become effective. See Section 107 of the Act.

## CONCEPT RELEASE

### **Appendix A – Excerpt From the Senate Hearings on the Securities Act of 1933**

During the hearings leading up to the passage of the Securities Act of 1933, Colonel Arthur Carter, President of the New York State Society of Certified Public Accountants, set out to convince the Senate Banking and Currency Committee that all registration statements should include financial statements audited by independent accountants. Some members of the committee were skeptical:

Senator BARKLEY. Is there any relationship between your organization with 2,000 members and the organization of controllers represented here yesterday with 2,000 members?

Mr. CARTER. None at all. We audit the controllers.

Senator BARKLEY. You audit the controllers?

Mr. CARTER. Yes; the public accountant audits the controller's account.

Senator BARKLEY. Who audits you?

Mr. CARTER. Our conscience.

Senator BARKLEY. I am wondering whether after all a controller is not for all practical purposes the same as an auditor, and must he not know something about auditing?

Mr. CARTER. He is in the employ of the company. He is subject to the orders of his superiors.

Senator BARKLEY. I understand. But he has got to know something about auditing?

Mr. CARTER. Yes.

Senator BARKLEY. He has got to know something about bookkeeping?

Mr. CARTER. But he is not independent.

Col. Carter was reacting to an early draft of the bill that contained no general audit requirement, but only a provision allowing the Federal Trade Commission to require an audit as part of an investigation. He also intended to persuade Congress that it should be the accounting profession, not the government, that should conduct the necessary audits:

Senator REYNOLDS. ... Would it not be creating more difficulty and more expense and more time for the Government if auditing organizations interest themselves in these various and sundry corporations?

Mr. CARTER. I do not think so. I think if a corporation wished to issue some securities and had been employing independent public

## CONCEPT RELEASE

accountants for 20 years those accountants should be able to make this examination more economically and quickly than the Government.

Senator REYNOLDS. Could they do it more economically than the Government?

Mr. CARTER. I think so.

Senator GORE. There would not be any doubt about that.

Senator REYNOLDS. Why?

Mr. CARTER. We know the conditions of the accounts; we know the ramifications of the business; we know the pitfalls of the accounting structure that the company maintains. You have got every kind of business to deal with.<sup>1/</sup>

In the end, once the legislative process had run its course, Congress agreed. It required, through Schedule A of the 1933 Act, that an issuer's financial statements be "certified by an independent certified or public accountant."

---

<sup>1/</sup> *Hearings on S. 875 Before the S. Comm. on Banking and Currency, 73<sup>rd</sup> Cong. 58 (1933).*