

To: Commets

From: Bradley Modenbach from Louisiana State University

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Re: PCAOB Rulemaking Docket Matter No. 37

The major financial reporting failures at Enron and WorldComm led to the financial reporting reforms contained in the Sarbanes-Oxley Act of 2002. SOA's reforms directly related to auditors which included the establishment of the Public Company Accounting Oversight Board (PCAOB), increased audit committee responsibilities, and mandatory rotation of lead and reviewing audit partners after five consecutive years on an engagement. I believe that a rotation of audit partners is critical in maintaining audit independence.

The ultimate question about mandatory audit firm rotation is whether such a policy enhances audit quality, and if so, at what cost. The primary audit quality question is whether such a policy will lead to more-independent auditors performing better audits by either detecting or reporting material misstatements in the financial statements, or whether the constant rotation of audit firms will result in inferior audit performance.

The nature of auditing requires that auditors interact extensively with their clients. Long-term relationships may result in a troublesome degree of closeness between management and the auditor. This is an important feature of our study because one of the primary motivating factors for the partner rotation provision in the SOX is to have a "fresh set of eyes" examine auditees' financial statements (Hatfield, Jackson, and Vandervelde). 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. 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 (Arel, Brody, and Pany). Had there been a "fresh set of eyes," then the scandal may have avoided.

I also believe that with no long-term connection to the client, the auditor does not face a conflict of interest and can act more freely. Under mandatory firm rotation, the auditor, the client, and the market all know that rotation will occur on a regular basis. Any deviation from the rotation schedule would likely be received negatively by all interested parties. Mandatory rotation would thereby remove much of the pressure an auditor might experience to negotiate. Knowing that another firm will take over the audit at some known

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future time increases the concern that the new auditors will detect any oversight, thereby adding to the pressure for the auditor to take a tough stand on any contentious issues.

The idea of enhancing auditor independence through mandatory audit firm rotation appeals to many. I believe that mandatory audit rotation reduces the possibilities of fraud and misstatements in financial reporting. I have considered that further research related to both audit firm rotation and these changes may lead to a more informed decision on mandatory audit firm rotation.