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To the members of the PCAOB Board,

Re: Rulemaking Docket No 37

I congratulate the Board on their thoroughly researched and well thought out Concept Release on Auditor Independence and Audit Firm Rotation. As an accounting/auditing researcher, auditing and accounting theory professor, and a reader of auditing research, I would like to offer my comments on the mandatory rotation proposal. My comments are organized along the following topics:

- 1) Is the research on mandatory rotation flawed?
- 2) In general, can or should research results be discounted?
- 3) Will mandatory rotation improve professional skepticism?
- 4) Discussions of other remedies

1. Is the research on mandatory rotation flawed?

The committee is clearly aware of all the academic research that has been conducted in this area and is aware that the empirical results are strikingly consistent: new auditors are at best as effective as long tenure auditors and in most cases are worse (Morrill, J. "Research on Rotation" *CA Magazine* 141(7) Sept 2008: 63-65). The research therefore strongly suggests that mandatory rotation is not only costly, but will end up causing a result that is opposite to the PCAOB objective of improving audits.

The committee has suggested that the research suffers from the flaw that nearly all the studies examined voluntary rotation. Therefore, the observed correlation between having a new auditor and having bad financial statements is effectively caused by a third factor, that these are difficult clients (who tend to change auditors and have bad financial statements). If this third factor drives the correlation, than a requirement to change auditors won't necessarily *cause* bad audits. This argument definitely has merits, although I would suggest the following counter-arguments:

- a) We do not know if this confounding factor is in place. It is possible that voluntary audit changers are similar and representative of the entire population , so the results of the research are valid for the entire population of firms of concern to the PCAOB
- b) There have been a few studies that have looked at INVOLUNTARY rotation that the committee referenced in note 81 (also see Blouin et al, 2007. "An Analysis of Forced Auditor Change: the Case of Former Andersen Clients" *Accounting Review* 82(3): 621-650). These studies, although limited, have found similar results. (Blouin *et al* found long term auditors were the same as new auditors)

- c) It can finally be argued that even if voluntary changers are difficult or more risky in some way, they are likely the types of firms that pose the most risk to capital markets. The research again shows that for these types of clients, new auditors are more likely to fail so mandatory rotation is risky.

2. *Can the PCAOB ignore academic research in favor of its own informed judgment?*

As an academic, I am uncomfortable with the PCAOB's approach to the non-audit services debate (admittedly a different issue) that was outlined on page 7. You argued that the research in this area "missed the point" and "simply did not prove that an auditor's judgment is unlikely to be affected because of an auditor's economic interest in a non-audit relationship". You further suggested that "the resolution of the issue must rest on our informed judgment rather than a mathematical certainty".

I respectfully disagree, and hope that the Board re-considers this approach. In the non-audit services (NAS) case, it is impossible for research to "prove a negative" and the Board would not accept a lack of positive evidence as proof. Instead, it relied upon their informed judgment based on what I am sure is a vast amount of personal, anecdotal, complex and probably mixed evidence. The committee members must be aware that just as "well-intentioned auditors, who, as with other people, sometimes fail to recognize and guard against their own unconscious biases" (pg. 9 of your document), the PCAOB inspectors may similarly overweight, underweight, or mis-perceive evidence. Mathematical certainties are more reliable, although issues such as the one discussed in the first section must be taken into account.

It is also not clear to me from the quotes provided in your document that the inspectors see the familiarity threat as the problem. In the quotes provided on page 8, all regulators reported concern and frustration with the lack of professional skepticism employed by the auditors, but only CPAB tied to greater familiarity or comfort with the reporting issuer. This leads to my third point.

3. *Will mandatory rotation lead to professional skepticism?*

It seems the Board is primarily concerned with improving professional skepticism (PS), and wishes to consider mandatory rotation as a possible way to strengthen it. First, there are many links in that chain which may not be particularly strong: a) Would mandatory rotation improve independence, which would indicate that the familiarity threat is very strong?; b) Does improved independence create objectivity?; c) Does improved objectivity lead to greater professional skepticism? In all cases it seems reasonable to believe that there is *some* link in that one facilitates the other, but it may not be as strong as the Board hopes. For example, the Board's Investor Advisory Group expressed concerns with the level of "coziness" between the firms and their auditors. Given the economic incentives, except in the last year of a mandatory rotation, I would expect that coziness to develop quickly and to last throughout an auditor's entire mandate if the auditor was inclined to be a "cozy" type.

Two recent articles may be helpful to the Board: 1) Nelson, Mark (2009) "A Model and Literature Review of Professional Skepticism in Auditing", *Auditing: A Journal of Practice and Theory* 28(2):1-34; and 2) Hurtt, Kathy, 2010. "Development of a Scale to Measure Professional Skepticism" *Auditing: A Journal of Practice and Theory* 29(1):149-171. In addition to acknowledging the incentive aspects of professional skepticism, these articles also suggest that professional skepticism contains knowledge components, traits, and judgments. These leads to my last section:

4. *Other remedies*

Following the models above, it is quite possible that the deficiencies in professional skepticism noted by regulators are due to a lack of education in critical thinking, training, or inadequate testing and screening by the profession at the point of certification. Improvements in these areas need to be emphasized by both the profession and educators like me.

I also approve the Board's consideration of mandatory *retention* in their document. While I have no evidence to support it (other than such systems of mandatory retention and/or multi-year appointments were used in Belgium, France, Italy, Japan, India, Spain, Sweden, and Switzerland¹), it has logical appeal to me. Like mandatory retention, it addresses the perverse incentives for auditors to be accommodating as they fear they may lose the client. Mandatory rotation deals with this fear by ensuring it comes true, but then places the audit in the hands a new auditor who may be less effective. Mandatory retention deals with this fear by ensuring it does NOT come true, and leaves the audit in the hands of the incumbent auditor.

Finally, the Board suggests the possibility of imposing mandatory rotation on the largest issuers. This would make sense to me if the drawbacks of mandatory rotation were primarily cost related. Since there are significant, perhaps overwhelming, concerns that mandatory rotation leads to worse audits, the proposal to limit it to any firms, much less very large ones that could have devastating impacts were they to fail, does not make sense to me.

I apologize for the length of my reply, but thank the Board for their careful consideration of this issue and their continuing efforts to protect the public interest.

Sincerely,

Janet Morrill

¹ This information comes from the "Doing Business in...." series of books published in the 1980's and 1990's.

