



April 22, 2012

Mr. J. Gordon Seymour
Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 2006-2803

Re: PCAOB Rulemaking Docket Matter No. 37, Concept Release on Auditor Independence and Audit Firm Rotation

Dear Mr. Seymour:

We appreciate the opportunity to submit comments to the Public Company Accounting Oversight Board (PCAOB) on its concept release on auditor independence and audit firm rotation (the Concept Release).

Our comments are based on our empirical findings (in joint work with Professor Joon Hwa Rho of Chungnam University, Korea) from the Korean audit market where auditor rotation has been mandated beginning in 2006. We are in the process of writing up our results, and will send you a copy of the paper when it is ready.

Overall, we fail to find that audit quality, proxied by absolute discretionary current accruals (ADCA), is higher in the initial three-year period subsequent to mandatory rotation, compared to that in the final three years of the previous auditor. We thus fail to find evidence that mandatory auditor rotation improves audit quality.

Because we study a setting where auditor rotation is mandatory, our research is able to provide evidence on several of the arguments made in the debate on mandatory rotation. Briefly, we find that auditors become less diligent towards the end of their term instead of becoming more diligent fearing discovery of deficiencies by a fresh pair of eyes; the Big 4 market share increases, and the largest of the Big 4 loses market share to other Big 4 auditors resulting in a decrease in the Herfindahl index of concentration; and clients are forced to move away from industry specialist auditors, which hurts audit quality.

The Concept Release questions the validity of accruals as a proxy (footnote 80, p. 37) so we validated our proxy using data from the Korean Financial Supervisory Service (FSS) reviews of financial statements and audit quality. The FSS reviews approximately 20 percent of the listed firms each year,

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chosen either by random sampling or from the suspicion that the financial statements are mis-stated. If significant mis-statements and audit deficiencies are identified, then the firm and the engagement auditor are sanctioned. We find that absolute discretionary current accruals are higher during and immediately preceding the period for which the auditor is sanctioned, compared to other client firm years, and to the same client firm in the post-sanction period.

Specific questions in the Concept Release and our findings

1. Does payment by client to the auditor inevitably create a distortion in the system (p. 17).

Apart from mandating auditor rotation in 2006, beginning in 1991 the Korean FSS designated (i.e., selected) auditors for selected client firms for selected years. We have a completed working paper on the topic (Bae, Gil S., Kallapur, Sanjay and Rho, Joon Hwa, Does Regulator Selection of Auditors Improve Audit Quality? Evidence from Auditor Designation in Korea. Available at SSRN: <http://ssrn.com/abstract=2037712>) showing that designated auditors did not have higher audit quality than did client-selected auditors. This suggests that client selection of auditors may not compromise auditor independence as much as is being thought. Or at least that regulator selection of auditors may not solve the problem if one exists.

2. Are auditors less or more diligent at the end of their audit term (Question 4, page 20)

This question can only be answered by studying a mandatory rotation setting as we do; in a voluntary setting auditors would not know when the end of their term is approaching. We find that audit hours in the pre-rotation period are significantly lower (at the 0.01 level) than those in other firm-years. This is consistent with the argument that auditors lose incentives to work diligently as the termination period approaches. It is not consistent with the argument that auditors would be more diligent towards the end of the allowable term for fear that a fresh pair of eyes might detect their shortcomings.

3. Effect on audit market concentration (Questions 7 and 8; also relates to “what are the advantages and disadvantages or unintended consequence of mandatory audit firm rotation, page 18)

The market share of the Big N auditors in terms of the number of clients remained stable at around 50 percent until 1997 (the year of the Asian financial crisis) and then slowly increased to high-50 percent by 2004. It, however, suddenly increased to mid-60 percent in 2005 and climbed further to slightly below 70 percent since then. When the Big N auditors’ market shares are measured by the total client assets or audit fees, the similar shifts, albeit less abrupt, seem to have occurred around roughly the same points of time. While the sudden increase in market shares of the Big N auditors coincides with the start of mandatory auditor rotation, we cannot be sure that it is attributable to mandatory auditor rotation.

When we examine the changes to and from the Big 4 auditors for switches caused by mandatory rotation, we find that mandatory switches resulted in a net increase in client for the Big 4.

Market shares within the Big N auditors in terms of the number of clients, total client assets, and total audit fees indicate that auditors with relatively smaller market shares tend to increase their market shares, and those with bigger market shares lose their market share during the mandatory auditor rotation period. Prior to the adoption of mandatory auditor rotation, PricewaterhouseCoopers (PwC) Samil was the dominant auditor in Korea by any standard—the number of clients, the total client assets, or the total audit fees; specifically, PwC Samil had more than 40 percent of the audit market by the

number of clients as well as the total client assets, and about 50 percent of the audit market by total audit fees. However, starting from 2005, PwC Samil continued to lose its market share, and by 2009, it was 27.4, 28.8, and 29.8 percent by the number of clients, the total client assets, and the total audit fees, respectively. In contrast, other Big N audit firms gradually increased their market shares.

The decrease in the market share of the largest among the Big 4 resulted in lower concentration measured using the Herfindahl index. One of us has a working paper (Sanjay Kallapur, Srinivasan Sankaraguruswamy, and Yoonseok Zang, 2010, Audit Market Concentration and Audit Quality, available at <http://papers.ssrn.com/abstract=1546356>) that finds lower concentration to be associated with lower audit quality.

4. Industry specialist auditor misalignment (relates to Questions 7 and 8, page 22; also relates to “what are the disadvantages (or unintended consequence of mandatory audit firm rotation, page 18)

To examine whether clients are forced to choose a less suitable auditor, and whether it affects audit quality, we examine clients of industry-specialist auditors who are forced to rotate their auditor. Consistent with the prior academic literature, we consider the largest auditor (we measure auditor size by client revenues, but find similar results if we use client total assets instead) in each industry to be the industry specialist.

In the first year of mandatory auditor rotation (2006), nine firms change auditors from a specialist auditor to a non-specialist auditor. In contrast, three firms change auditors from a non-specialist auditor to a specialist auditor. Similar findings hold in each of the years, 2007, 2008, and 2009. In total, 22.1 percent of the clients change auditors from an industry specialist to a non-specialist, and 11.4 percent change auditors from non-specialist to a specialist. Thus industry specialist auditors lose market share as a result of mandatory rotation. In contrast, industry specialists gained market share every year prior to mandatory rotation.

Regarding audit quality, we find that the decrease in quality (during the first three years of the new auditor compared to the last three years of the old auditor) is significantly higher for clients switching from industry specialist to non-specialist auditors compared to other switches. Taken together, these findings show that mandatory auditor rotation has the unintended side-effect that industry specialist auditors lose market share and this affects audit quality.

In conclusion, based on our findings described above, and the findings of previous research that most audit failures occur early in an auditor’s tenure, we feel that the costs of mandatory rotation far exceed any potential benefits.

If you have any questions please feel free to reach us by e-mail at gilbae@korea.ac.kr or sanjay_kallapur@isb.edu.

Sincerely,

Gil S. Bae, Professor of Accounting, Korea University Business School,
Sanjay Kallapur, Professor of Accounting, Indian School of Business.