Comments on PCAOB concept release on auditor independence and audit firm rotation

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In a published paper entitled “Improving Auditor Independence Through Selective Mandatory Rotation (jointly co-authored with Pradyot Sen) we constructed an economic model that considered external auditors incentives to maintain independence from the client under two regimes – one in which there was mandatory rotation and another where there was not. The paper showed how rotation improved incentives for independence but at the cost of the periodic need for a new auditor to invest in learning about the new client.

The major result in the paper was that even though rotation is costly, in certain well defined cases, thin markets, the benefits outweigh the costs because in thin markets auditors incentives to maintain independence are weakest.

I suggest that the above research in part addresses Question 6, (PCAOB pg 21): Should the board consider requiring rotation for all issuer audits or just for some subset, such as audits for large issues?

Requiring rotation in all markets could be excessive. Motivated by the earlier research with Pradyot Sen I suggest that consideration be given to introducing rotation in those markets where external auditors economic incentives to maintain independence are most at question.

The above research suggests that in the first instance rotation should be introduced were audit markets are most thin. To make this statement operational one needs to inquire what empirical proxies for “thinness” could be used. In the research paper thinness is modelled by F/f, current assignment fee divided by future normal fees.

Essentially if one client’s fees dominate the overall auditor’s fee income then we have a thin market and the research would favour rotation. However, for the large international audit partnerships with large portfolios of clients it may not be able to identify dominant clients. Instead the analysis of whether thin markets exist needs to be done at the operational unit level – Regional or City offices. It is interesting to notice in the case of the Houston office of Arthur Anderson – the relationship with Enron clearly gave rise to thin market operating conditions consistent with conditions identified by our theory of when rotation would be desirable.

Another element of producing an empirical proxy for the F/f ratio could be to look at other fees as a proportion of audit fees. When clients repeatedly request professional services work additional to the audit, such clients may be viewed by external auditors as star clients. Thus another way to identify cases where auditors economic incentives to maintain independence are weakest would be to identify those cases where non audit fee income is a significant proportion of audit fees – again conducted at the Regional or City office level.

In terms of the most common argument against introducing rotation, the literature that takes a negative position on mandatory rotation often refers to data provided by studies such as AICPA 1992. That study reports that audit failures are more likely to happen in the early years rather than in later years and hence it is argued that this suggests rotation will introduce more (early year) audit failures. In the above research paper (Section 7) we argue that such "conclusions" cannot validly be drawn from the data because they suffer from severe self-selection problems.

In addition to the above earlier research on rotation my current research on SEC Comment Letters (jointly with Helena Isidro and Angela Pettinicchio) suggests a new idea that identifies an additional policy instrument "that the Board should consider that would meaningfully enhance auditor independence, objectivity and professional scepticism" (PCAOB pg 19)?

It is now clear a significant number of SEC registrants are receiving Comment Letters and that they are having important effects on reporting practice. For instance for a small sample of foreign registrants reporting under IFRS my research (jointly with Helena Isidro) has shown that approximately 40% of registrants agreed to revise and amend disclosures in future years following a Comment Letter "exchange" with the SEC.

Comment Letters are the primary responsibility of registrants to address, not the external auditor. However many of the Comment Letters ask very detailed questions about the application and use of accounting. These are clearly issues the external auditor should be concerned about.

My informal suggestion is that after a Comment Letter exchange has been completed the Audit Committee be tasked with reviewing the role of the external auditor in the process. If the registrant agrees to change disclosure practice, a report could be written explaining why the external auditor did not proactively propose such changes during the normal practice of the audit.

Clearly this proposal may give rise to some issues and needs careful development, however I suggest that now that for the first time the SEC is producing in depth public Comment Letters on a systematic basis, this information should feed into the appraisal of the auditor's relative independence.