

Statement
Of
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Before
PCAOB Roundtable on Auditor Tenure
San Francisco, California
June 28, 2012

My name is James D. Cox. I am Brainerd Currie Professor of Law, School of Law, Duke University where my research and teaching focuses on securities and corporate law. Prior to joining the Duke faculty in 1979, I taught at Boston University, University of San Francisco, University of California, Hastings College of the Law, and Stanford University School of Law. I am currently a member of the Standing Advisory Group of the Public Company Accounting Oversight Board. In the past, I was a member of the New York Stock Exchange Legal Advisory Committee, the National Association of Securities Dealers Legal Advisory Board, and the Committee of Corporate laws of the Business Law Section of the American Bar Association. Among my publications are Securities Regulations: Cases and Materials (6th ed. Aspen 2009)(with Langevoort and Hillman), which has been adopted in approximately two-thirds of American law schools, and a multi-volume award winning treatise, The Law of Corporations (3d ed. 2010)(with Hazen). The views I express here are my own and are not on behalf or to be attributed to any of the before mentioned organizations.

Professional skepticism is the calling of a good auditor. Financials statements are prepared by management and it is the managers who bear responsibility for their content. But authenticity to their firm's financial statements comes about through the auditor's verification that the financial statements are supported by economic activities summarized in the statements that are reported according to generally accepted accounting principles (GAAP). The efforts to verify both the existence of the reported on activities and compliance with GAAP calls for auditors to probe, test and otherwise challenge the assertions set forth in management's statements. This requires unquestioned independence on the part of the auditor. Hence we find the expressions "outside" auditor or "public" accountant.

Over the last few years, multiple developments have made the auditor more independent. The New York Stock Exchange and Nasdaq listing requirements mandate not only that listed companies have audit committees, but that the committee be comprised of non-management directors. The Sarbanes-Oxley Act of 2002 requires that the auditor's selection, renewal, and termination must be made by the audit committee, not by the executive officers or, for that matter, the board of directors. The Act also prohibits the auditor from providing an extensive range of non-audit services, thus avoiding the auditor's sought for skepticism being compromised by lucrative consulting work. Nonetheless, there continues to be repeated instances of failed audits that are best explained by a lack of professional skepticism.¹

¹ See e.g., In the Matter of Ernst & Young, LLP. et. al., PCAOB Rel. No. 105-2012-001 (Feb. 8, 2012)(auditors, in clear violation of SFAS No. 48 allowed estimates sales returns to be based on replacement costs;

For example, we might well ponder the role lack of professional skepticism played in the early days of the financial crisis that reached a head in late 2008. Not a single large bank received a qualified opinion at the close of that year's business. To be sure, this may represent tacit understanding of the implicit guaranty of the U.S. government. However, financial distress was very much present and avoided for most by their access to the Fed's discount window. Moreover, other statistics suggest that auditors broadly fail to qualify their opinions when financial distress is in the winds. Data reveals that during the ten-year period 2000-2009 that auditors failed to qualify their opinion on the going concern basis in more than one half of the instances in which reported companies failed within one year of the financial statement date.² We might also wonder whether auditors shy away from raising these issues in part because of a lack of professional skepticism.

Auditor failure can be due to multiple contributing forces. Audit committee members, the auditor's boss, are themselves time and information bound. Although the audit committee agenda is full, and its member's briefing books bulge, the committee's members are dependent on the candor of the auditor to identify areas of concern. Thus, the audit committee, charged with overseeing the auditor, is in turn dependent on the auditor. If there is a breakdown with the auditor, then there most certainly will be a breakdown with the audit committee. And, any forces

when resisted internally switched justification to incorrect reliance on SFAS No. 5 as a loss contingency. Moreover, despite a good deal of contradictory information the auditors accepted management's assumptions regarding likely returns). Board member Jeanette M. Franzel recently reported that the PCAOB's inspections have identified an unexplained increase from prior years in audit deficiencies. *See* 44 B.N.A. Securities Regulations and Law Reports 997 (May 14, 2012).

² Carson, Elizabeth, Fargher, Neil L, Geiger, Marshall A., Lennox, Clive S., Raghunandan, Kannan & Willekens, Marleen, Auditor Reporting on Going Concern Uncertainty: A Research Synthesis (Working Paper Jan. 30, 2012) available at SSRN://com/abstract=2000496.

that compromise the auditor will necessarily compromise the audit committee's oversight of not just the auditor but the financial reporting process.

Auditor tenure can be such a conflicting force. An auditor-client relationship that has a life of 10 years is likely to have less of a pull on the auditor than one believed to be perpetuity. With the relationship for a finite term, the value of the relationship declines with each successive year; with the perpetuity, it never declines. Moreover, with the term, there is the awareness that another auditing firm will someday, perhaps soon, be retained that can be expected to eagerly probe for lapses committed by the competitor who preceded it.³ Thus, we might well expect outgoing auditors to be as diligent as the newly retained auditor. In the end, the professional skepticism that is the linchpin for a good audit is strengthened by imposing limits on auditor tenure.

On average, the tenure of auditors is fairly stable among large public firms. One study reports that among Fortune 1000 firms, 59 percent of the firms have had the same auditor for over ten years (nearly one-fourth have had the same auditor for 21 or more years).⁴ Despite these statistics, auditors do change, albeit among smaller firms, and with some regularity. In the year following the disappearance of Big Five accounting firm Arthur Andersen 22.1 percent of reporting companies changed auditors. A more normal experience was the 11.3 percent and 10.5 percent changes in 2005 and 2006, respectively. Roughly half of all public companies changed their auditors in the five-year 2002-2006 period.⁵ The irony of these statistics is that changes

³ See studies cited in note 10, *infra*.

⁴ Kate Iannelli, Mandatory Audit Firm Rotation: Explaining the Key Numbers, Directorship.Com (March 22, 2012), available at <http://www.directorship.com/mandatory-audit-firm-rotation-explaining-the-key-numbers>.

⁵ Mark Grothe & Thomas R. Weirich, Analyzing Auditor Changes: Lack of Disclosure Hinders Accountability to Investors, The CPA Journal Online (Dec. 2007) available at <http://www.nyscpea.org/cpajournal/2007/1207/infocus/p14.htm>

occur more frequently for small than large firms;⁶ it is the small firms for whom audit fees are relatively more significant vis-à-vis revenues and income so that the burdens of switching auditors is disproportionately larger.

Assessing the costs and benefits in this area is intriguing in terms of identifying just what are the costs and what are the benefits to be measured. Stability of auditor may well mean more than a quiet life for the auditor; there is evidence that the lengthy tenure equates to lower auditor costs.⁷ However, reporting companies must change audit engagement partners every five years.⁸ With a new engagement partner unfamiliar with the intricacies of the audit client's operations and reporting systems, there is every reason to believe there are non-trivial costs associated with the current legal requirement that engagement partners be switched periodically. We might therefore conclude that this requirement could be relaxed if reporting companies were required to change audit firms periodically. Thus, the marginal cost of this report would be offset to some extent by the costs related to the current regime where audit engagement partners are switched. And how do you classify the fact that companies that switched auditors in 2006 had nearly triple the number of restatements as firms that did not change auditors?⁹ To the extent that auditor rotation leads to greater accuracy and hence trustworthiness of the firm's financial reporting this

⁶ *Id.* (firms with a market capitalization of less than \$75 million change auditors at a rate of 63% whereas companies with a market capitalization of at least \$2.5 billion have an 8% turnover rate).

⁷ Robert B. Lamm, Society of Corporate Secretaries & Governance Professionals Response to PCAOB Rulemaking Docket Matter No. 37, available at <http://www.governanceprofessionals.org/society/default.asp> (citing to survey of corporate secretaries where 70 percent of members estimate initial audit year costs would be 20 percent higher if mandatory rotation of auditors was required). Kate Iannelli, n. _ *supra* (“[d]ata from Audit Analytics suggests these increased costs aren't isolated to the first year of an engagement; in both the Russell 1000 and the Russell 2000 companies with auditor tenure of five years or less paid substantially more in audit fees . . . than companies with longer tenure).

⁸ Sarbanes Oxley Section 203 amending Securities Exchange Act Section 10A(j), 15 U.S.C. 78j-1.

⁹ Mark Grothe & Thomas R. Weirich, note _ *supra*. (reporting that 27 percent of the companies changing auditors in 2006 restated earnings within one year of the switch compared to 10 percent of the companies not switching auditors). Another questionable cost is that 69 percent of the firms changing auditors in 2006 were late in filing at least one SEC quarterly or annual report versus 27 percent of all public companies. *Id.*

in turn should be counted not as a cost of the change but a measureable benefit in reducing the firm's cost of capital. Indeed, studies do reflect that a new audit firm enhances audit quality and, hence, the trustworthiness of financial reports.¹⁰

This is not likely an area where self-policing by an independent audit committee will naturally lead to a practice of periodic rotation of auditing firms. In this connection, consider the research findings that upon undergoing a restatement that it is three times more likely that a non-Big 4 accounting firm will be terminated than if the need for the restatement is attributed to a Big 4 accounting firm.¹¹ There are multiple explanations why small audit firms are a more likely to be terminated when a restatement flows from practices that occurred on the small audit firm's watch. First, small audit firms are most likely the auditors of smaller, less complex firms. Hence, the total cost of switching auditors is not nearly as great as is the costs for the large client of a Big 4 firm; albeit, as noted earlier, to the extent there are additional costs related to switching auditors the costs relative to assets, revenues and earnings are more significant than for a much larger issuer. Second, changing auditors in the context of the restatement is associated with a favorable impact on their cost of capital.¹² The market's favorable reaction no doubt reflects the

¹⁰¹⁰¹⁰ See e.g., Lazer, Ron, Joshua Livnat & Christine E.L. Tan, Restatements and Accruals After Auditor Changes, (Feb. 2004) (firms experiencing auditor changes in 1988-2002 reported significantly higher incidence and magnitude of quarterly restatements than firms that did not change auditor); Li Z. Brooks, C.S. Agnes Cheng & Kenneth J. Reichelt, Audit Firm Tenure and Audit Quality: Evidence from U.S. Firms, (working paper Apr. 10, 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2037659 (finding audit quality begins to degrade around 12 years so that the optimal tenure would be 10-14 years). Consider here as well the finding that firms who have terminated their auditors, but the auditor continues to wrap up the on-going audit, that there are statistically smaller discretionary accruals than occur with non-lame duck auditors. See Cory A. Cassell, Linda A. Myers, Timothy A. Seidel & Jian Zhou, The Effect of Lame Duck Auditors on Management Discretion: An Empirical Analysis, (Working Paper April 2012), available at, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1957323.

¹¹ See Karen M. Hennes, Andrew J. Leone & Brian P. Miller, Accounting Restatements and Auditor Accountability (Dec. 31, 2010, available at, <http://ssrn.com/abstract=1735675> (examining 1325 restatements in the 1997-2006 period).

¹² *Id.*

awareness that in general small firms have a weaker control environment such that a fresh set of eyes is more of a positive effect than in the more stable controls environment of larger firms. Third, Big 4 audit firms already confer a halo on the audit client so that shifting from one high reputation auditing firm to another is not likely to produce the same favorable impact on the firm's cost of capital as with the smaller firm shifting from among non-Big 4 accounting firms. That switch will nonetheless be seen as board's commitment to improve financial reporting.

There is little doubt that the Public Company Accounting Oversight Board (PCAOB) enjoys the authority to mandate auditor rotation. Created by Sarbanes-Oxley, the PCAOB enjoys broad authority over the professional standards governing auditors of reporting companies. Therefore, SOX Section 103(a) clearly provides:

The board shall, by rule, establish . . . such quality control standards, such as ethics standards, and such independence standards to be used by registered public accounting firms in the preparation and issuance of audit reports

As seen earlier, the bedrock of professional skepticism is auditor independence so that all standards guiding auditors rest upon the fundamental principle that the auditor is independent of its audit client. This conclusion is dramatically underscored in the historic Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 which amended SOX 103 to expressly provide that professional standards include "independence standards."¹³ Indeed, in light that SOX called on the Government Accountability Office to undertake a study of auditor rotation and the resulting study provides multiple bases of support for auditor rotation, the amendment of

¹³ Dodd-Frank section 982(d) amending Sarbanes-Oxley Act section 103(a). Dodd-Frank further amends section 110(5)(B) to provide that standards of independence relate to the preparation of audit reports. Moreover, the recently enacted Jumpstart Our Business Startups Act (JOBS Act) further supports the presence of the authority to mandate auditor rotation; the JOBS Act expressly provides that "emerging growth companies" are immune for as long as five years from any requirement of mandatory audit rotation.

SOX expressly including “independence” among the standards for which the PCAOB has responsibility, conclusively supports the authority of the PCAOB to invoke auditor rotation as a component of the independence criteria of auditors.

As the PCAOB considers auditor rotation, there are several possible courses of action it might pursue. One, of course is to do nothing. The evidence collected above challenges such inaction. At the other end of the spectrum of choices is to mandate periodic auditor rotation. A variance on this proposal would be requiring reporting companies periodically placing their audits up for competitive bidding, and allowing the current auditor to bid against competitors. Complementing this approach could be disclosure requirements on the company to explain its ultimate choice of auditors. A further approach is to view auditor rotation as part of the sanction imposed whenever the PCAOB discovers substantive violations of auditing standards. That is, upon finding a serious departure from auditing standards, particularly a failure of professional scrutiny, the PCAOB can require the auditor to cease work for a firm with whom it has had a long-term relationship.¹⁴ Finally, among the heuristics the PCAOB uses to identify audit firms to inspect, and the particular audits of the identified firm, could be the duration of the auditor’s tenure with a particular client. Indeed, auditor tenure can easily be seen as one of many risk factors to consider in any ex ante consideration of where an audit failure is likely exist. In the event that the contemporary political climate, which has a marked reserve regarding the benefits of regulation, discourages mandatory audit rotation becoming a fixture for reporting companies, there is a further approach. That would be heightened disclosure, most likely in the audit opinion letter, of the length of time that the auditor has been the auditor of the firm’s statements.

¹⁴ This approach likely would require legislation to expressly authorize the PCAOB to include this sanction among the remedies it might impose.

