Statement of Greg Jenkins, CPA
Professor of Accounting & Information Systems and William S. Gay Fellow
Virginia Tech

Chairman Doty, members of the Board, and others, it is my privilege to speak with you today about auditor independence and mandatory firm rotation. I would like to begin by noting that I currently serve on a team of academics selected by the Auditing Section of the American Accounting Association to synthesize academic literature and other data that are relevant to the Board's consideration of mandatory firm rotation. My team provided a draft report to the Board on December 22, 2011.

My remarks this afternoon are my own and are not intended to represent the views of my synthesis team members, the American Accounting Association, or the Auditing Section.

Auditor independence has been the subject of a significant body of research over the years. I would like to briefly describe what this body of research reveals about the influence of client economic importance, the provision of non-audit services, rotation, and tenure on auditor independence. I will conclude my remarks by sharing data related to audit firm tenure.

Economic Importance

Concerns related to client economic importance are based on the notion that auditors become so economically dependent on clients that they may be willing to compromise audit quality to maintain the client relationship. U.S. based research does not reveal an empirical basis for these concerns. However, there is some non-U.S. based research which does find a positive association between client importance and impaired independence.

The differences in the findings of the U.S. and non-U.S. based studies appear to stem from differences in regulatory environments and corporate governance practices. For example, one non-U.S. based study examined data from New Zealand, a country with a self-regulated accounting profession that operates in a generally weaker corporate governance environment. Companies are not required to establish particular oversight mechanisms such as audit committees and there is no ban on the provision of non-audit services to audit clients in New Zealand. A second example relates to China. Findings of impaired independence are limited to a period of time with a weak legal environment and regulatory oversight of the accounting profession. However, following a period of substantial legal and regulatory reform in the early 2000s, there is no evidence of impaired independence. Given the current legal and regulatory environment in our own country, it seems unlikely that the findings of impaired independence observed in these non-U.S. studies translate to the U.S.

Influence of NAS

As with the matter of economic importance, numerous studies have examined the influence of an audit firm providing non-audit services to audit clients. These studies have investigated the

impact of non-audit services on earnings management, perceptions of auditor independence, the need for restatements and the issuance of going concern opinions. The overwhelming majority of these studies find no evidence to indicate that the provision of non-audit services to an audit client leads to impaired independence. An exception to this overall observation is the finding by some studies that the provision of non-audit services leads to a *perceived* loss of independence. However, a recent study that examines pre- and post-SOX data suggests that investors no longer perceive such a loss of independence.

Some have expressed concerns that audit firms are earning significant amounts by providing greater levels of non-audit services to their audit clients. An analysis of the audit and non-audit fees paid by the Fortune 500 from 2002 through 2010 is not consistent with this assertion. The level and mix of fees associated with audit and non-audit services following the initial years of implementing Section 404 requirements have been quite stable. In fact, audit fees have averaged $8.9 million while non-audit services fees have averaged $2.4 million since 2007. The non-audit services fees result almost entirely from audit-related and tax services.

Rotation and Tenure

The academic findings on auditor rotation are mixed with no clear picture as to whether rotation is beneficial. Adding to this lack of clarity, is the increasing realization that the association between auditor tenure and audit quality is rather complex. The relationship appears to depend on various factors such as the length of term limits, audit complexity, industry specialization, and the legal liability environment.

I would like to now turn to some preliminary data analysis related to auditor tenure at U.S. public companies for 2010 - the most recent whole year for which vendor-provided data are available. The average tenure of an auditor for public companies in the U.S. at the end of 2010 was 9.8 years. Tenure is relatively similar for Deloitte, Ernst & Young, and KPMG with an overall average of approximately 10.4 years. PWC has the longest average tenure at 12.1 years. The 16 next largest firms have a combined average tenure of 4.7 years.

Tenures differ substantially across industries. For example, companies in the financial, pharmaceutical, and computer industries are audited by firms with the shortest average tenures of 8.1, 8.3, and 8.9 years, respectively. Companies in the durable manufacturing, chemicals and foods industries are audited by firms with the longest average tenures of 12.2, 14.3, and 14.9 years, respectively. I bring these data to your attention because they indicate possible differential effects of varying firm rotation requirements across industries.

There may be differential effects on the very largest audit firms as well. An analysis of the client portfolios of these firms reveals varying degrees of industry concentration at the end of 2010. For example, KPMG audits the greatest number of companies in the financial industry, while PWC audits the largest proportion of the industry based on market capitalization. Take another example - Ernst & Young audits 40 percent of the companies in the pharmaceutical industry, yet PWC audits almost 50 percent of the industry based on market capitalization. Other industries

such as retail and utilities are mostly audited by Ernst & Young and Deloitte, both in terms of the number of clients and the relative market capitalization.

Industry concentration such as this reflects the market's endorsement of the industry specialization of these firms. Indeed, this endorsement is supported by fairly strong evidence. Research indicates that industry specialization is closely associated with improved financial reporting quality, improved disclosure quality, fewer financial statement frauds, and fewer restatements.

Mandatory firm rotation may have significant unintended negative consequences for companies that require specialist auditors if they are required to retain an audit firm that possesses less industry specialization than their former firm.

I thank you for the opportunity to speak to you today, and I hope my remarks have been informative. I look forward to your questions.