

Statement of Robert C. Pozen Before PCAOB Roundtable on Mandatory Rotation of Auditors
(March 22, 2012)

Board Members of the PCAOB,

Thank you for this opportunity to join this distinguished panel in discussing the PCAOB's concept proposal on mandatory rotation of auditors. I am participating in the panel in my personal capacity, and not as an official representative of the institutions named below. I am a senior lecturer at Harvard Business School and senior fellow at the Brookings Institution. I am also a member of the Audit Committee of two public companies – Medtronic, Inc. and Nielsen, Inc.

In the written comments to the PCAOB and the remarks of panel members, you have heard strong arguments for and against mandatory rotation of auditors. In this statement, I recommend that the PCAOB adopt a middle ground – requiring the audit committees of public companies periodically to issue a request for proposal (RFP) for auditing services, but allowing the existing auditor to bid on this RFP. In my view, this approach would reinforce the accountability of the external auditor to the audit committee, rather than management, without imposing some of the costs associated with mandatory auditor turnover.

A. Background

I start from the premise that effective auditing depends primarily on a high degree of involvement and oversight by the audit committee, as distinct from company management. Under the Sarbanes Oxley Act (SOX), the external auditor of a company reports to its audit committee, composed entirely of independent directors with appropriate expertise. The audit committee retains the external auditing firm, sets its fees and determines the scope of its engagement. In addition, the auditor is obligated to tell the audit committee about any significant differences with management on accounting matters.

In certain situations, however, the audit committee seems to have been unaware of problematic accounting decisions made by management with the advice and consent of the company's auditor. This seems to have occurred, for example, at Lehman Brothers and Enron. In these situations, the auditor may have felt a stronger loyalty to company management than the audit committee.

More generally, there are many situations where the auditor was chosen by the company before the passage of SOX in 2002. Over 58% of the public companies in the Russell 1000 had auditors with tenure of 11 years or more, according to Audit Analytics¹. In these situations, it is unclear whether the auditor recognizes its primary loyalty is to the audit committee, rather than company management.

Thus, in my view, the key question is whether auditor rotation reinforces the primacy of the audit committee over company management in the eyes of the auditor. Such reinforcement is likely to occur if the audit committee, assisted by its own independent experts, conducts a bidding process for the company's auditor. The audit committee would issue a request for proposals (RFP), accept proposals from various firms and ultimately choose an auditor for the company.

¹ Auditor tenure was 11-20 years for 22.8%, 21-40 years for 19.8% and 40+ years for 16.1% of the Russell 1000 companies. "Auditor Tenure, Financial Officer Turnover, and Financial Reporting Trends" (December, 2011)

On the other hand, the benefits of this RFP process do not necessarily require that the audit committee choose a new firm to perform the company's audit. The RFP process itself bolsters the role of the audit committee by making clear that it has the power and responsibility to select and terminate the company's auditor. After the RFP process, the audit firm would owe its allegiance to the audit committee, rather than the company officers who appointed that firm before the passage of SOX.

B. Proposal

In light of these considerations, let me formulate a specific proposal to promote the RFP process for choosing an auditor, and then discuss its likely costs and benefits. The PCAOB could require the audit committee of every publicly traded company to hold a RFP process for its auditor at least once in any designated period such as 10 to 20 years². The existing audit firm would be allowed to submit a proposal in response to the RFP and be chosen by the audit committee—if the committee members determined that the existing audit firm would likely perform the highest quality audit relative to costs over the designated period.

Although the RFP process imposes a modest burden on the public company, it will probably receive higher benefits in the form of lower audit fees from competitive bidding. In addition, from my experience with RFPs in similar circumstances, there will probably be substantial benefits in the quality of service as the existing provider vies to retain its contract. More broadly, the possible appointment of a new auditor should encourage the existing auditor to do a better job. The existing auditor would be worried that any deficiencies or mistakes in its audit would be discovered if a new auditor were subsequently appointed.

These benefits would flow from the RFP process and the potential appointment of a new auditor, not the actual replacement of the existing auditor. To retain the engagement, the existing auditor would have strong incentives to develop expertise and knowledge about its current client. The existing auditor would also have strong incentives to offer the audit committee a proposal with significant cost reductions and service improvements. Accordingly, I would expect that the audit committee would choose to continue with the existing auditor in 80% to 90% of the cases.

In those 10% to 20% of the cases where the audit committee choose a new auditor, there would be transition costs incurred by the company. In a large company, the new auditor would take a year or two to get up to speed on all the activities and issues relevant to the new audit engagement. However, these transition costs will be taken into account by the audit committee in the RFP process. If the total costs of hiring a new auditor are excessive in this particular situation, the committee members will presumably not go in that direction.

C. Counter-Arguments

There are several counter-arguments that will probably be made to my proposal. However, as explained below, none of these seems persuasive.

1. There are not enough qualified audit firms to have a viable RFP process on the audit engagement for huge multinational companies

² The period should be long enough to encourage new audit firms to bid for the engagement and incur the start-up costs.

For huge multinational companies, only three global audit firms would be likely to bid in a RFP process – beside the existing one. Of these three other firms, one (or possibly two) will already be engaged by the multinational to perform non-audit services.

However, a RFP process can be viable with only two serious bidders – the existing auditor and another firm in the Big Four. In many competitions for service contracts, the process comes down to two credible bidders. If a firm other than the existing auditor already performs non-audit services for the company, that other firm will be especially credible as a possible replacement for the existing auditor³. The other firm will be known to the board and management, so the audit committee would feel more comfortable selecting this other firm than a complete stranger.

2. The existing auditor will almost always be selected by the audit committee, so other audit firms will not bid in the RFP process

As discussed above, it is the RFP process – not the replacement of the existing auditors – that produces most of the benefits from my proposal. These benefits will accrue even if the committee replaces existing auditor in only 10% or 20% of the cases. Such a replacement rate should be sufficient to attract bidding in many situations from other Big 4 firms since these are long-term and profitable engagements. Indeed, if my proposal were adopted, I would expect that all of the Big Four would establish specialized units dedicated to answering RFPs from audit committees.

Moreover, the requirement for a periodic RFP process will increase the chances of middle-size audit firms expanding the size of their client base. These middle-size auditors have little incentive to develop their capabilities of serving larger clients under the current system, where the auditors of large public companies are almost never terminated. By contrast, if these engagements were periodically put out to bid, then middle-size firms would be motivated to develop their skills and enter the RFP process in a broader range of public companies.

3. The RFP process would make audit firms more accommodating to management, since these firms would be worried about being replaced in the next RFP

Yes, the RFP process will make the existing audit firm more responsive to the wishes of the group who controls the RFP process. But that group will be the independent directors on the audit committee, not company management, since those directors will be running the RFP process. For this reason, it is critical that the audit committee have the ability to retain independent experts to help design and run the RFP process, and not rely entirely on company management for these supporting functions.

If the existing auditor becomes more responsive to the audit committee as a result of the RFP process, that process will be a great success. The PCAOB wants the external auditor to be more forthcoming with the audit committee about any material issues with the financial statements. Such a closer relationship between the auditor and the independent audit committee should be an integral part of the PCAOB's efforts to improve the audit process.

³ Of course, if the other firm were chosen as the auditor, it would have to give up performing most or all of these non-audit services for this company.

D. Conclusion

In conclusion, I do not favor mandatory rotation of auditors as a blanket rule. In many situations, the costs of hiring a new audit firm would probably exceed its benefits. A better approach would be to require the audit committee to issue a RFP periodically for the auditor engagement, while allowing the existing auditor to bid in the RFP process. This approach would reinforce the primacy of the audit committee to the audit firm, who would also be worried that its deficiencies would be exposed if and when the firm were replaced. But this approach would entail only the modest cost of running the RFP, unless the existing auditor were actually replaced. In that event, the members of the audit committee would presumably have decided that the costs of switching auditors were outweighed by the benefits of switching.

Thank you again for this opportunity to participate in this roundtable. If you want to discuss this matter in more depth, please feel free to contact me.