Opening Comments to PCAOB

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Chairman Doty, other members of the PCAOB, and the PCAOB staff, it is an honor to speak with you this morning. I would like to start by saying that in my thirty years in the accounting profession as a student, and auditor, and now an academic, I believe the intensity of the discussions about the independence and objectivity and professional skepticism of auditors is well-justified given the importance of the topic to our profession and to the efficient functioning of our capital markets. The issue before the Board today (and in Brussels) is one that clearly represents a structural shift - and warrants careful consideration of the cost as well as the benefits (both real and perceived).

As a coauthor of the BNA Portfolio entitled *Auditor Independence*, I document (with my coauthor) changes to auditor independence rules for nearly a century in the U.S. Admittedly, a few changes represent structural shifts in the regulations, while many others (in my opinion) are merely attempts at tinkering around with the edges. In my research for the portfolio on auditor independence for BNA and my other professional experiences, an overriding theme for auditor independence rules is clear. The rules serve two related public policy goals. First, the rules are intended to minimize the possibility that external factors will influence an auditor's judgments while performing financial statement attest functions. Second, the rules are intended to promote investor confidence in the financial statements of public companies.

Before discussing some of the literature on auditor rotation, I note that in the U.S., we currently operate in a regulatory environment in which the value of most auditor-client relationships (to audit firms) can be estimated as the present value of annuity streams of twenty, thirty, or even more audit engagements periods. Indeed, the auditor tenures of Enron and Waste Management and WorldCom and other audit failures do not simply go back a decade or two (or three). The length of those relationships before discovery of the accounting frauds can be traced back to the IPOs of those registrants. Thus, investigating audit quality in a voluntary auditor switching environment may not yield generalizable empirical audit evidence to a regulated rotation environment since voluntary changes could indicate nonpublic problems of clients. On the other hand, some research, however, does suggest that audit firms are quite capable of responding efficiently to changes in capacity (e.g., see some of Karen Nelson's, with Brian Rountree and Wayne Landsman in 2007).

With that in mind, in a study of a voluntary switching environment, (Sankaraguruswamy, Whisenant, and Willenborg 2012) my coauthors and I control for some of these confounding effects other than price competition by investigating the audit quality of auditor switches in which price competition appears to have been one primary factor for the change. We show, contrary to some predictions that, although the U.S. now requires public disclosure of audit fees, economically significant discounts for initial audits continue to be negotiated when companies switch from Big4 to other Big4 audit firms. The discounting of initial audits for companies that switch auditors, however, essentially ends by the second year of the engagement relationship. More importantly (at least to this discussion today), we find no evidence that lower audit quality exists for those clients receiving initial audit discounts using both restatements and going-concern opinions as proxies for measuring audit quality.

Much has been made of the potential costs of mandatory auditor rotation, but few studies report on the potential benefits of mandatory auditor rotation (in part due to the fact that only a few countries have adopted such a regulatory practice). Vanstraelen (2000) investigates the impact of renewable long-term audit mandates on audit quality. The results of the study suggest that long-term auditor client relationships significantly increase the likelihood of an unqualified opinion (i.e., lower audit quality) except when the long-term audit mandate is in its last year. She concludes that findings could be in favor of mandatory auditor rotation to maintain the value of an audit for the external users.

In a study in which the goal was to provide evidence to the debate on mandatory auditor rotation, Harris and Whisenant (2012) provide empirical evidence of the potential costs and benefits of mandatory auditor rotation (MAR) rules by investigating whether rotation rules are associated with changes in the quality of audit markets; most especially, the amount of unexpected opportunistic discretion in earnings before and after adoption of rotation rules. Using available data from countries that have adopted rotation rules, we first investigate the debonding effect of a rotation policy (i.e., enhancing of auditor independence in audit markets). A comparison of all available years of data in the pre-adoption period with those in the post-adoption years gives evidence of less earnings management, less managing to earnings targets, and more timely loss recognition in the post-adoption than in the pre-adoption sample period. We conclude that the quality of audit markets (as defined here) improves, on average, after enactment of rotation rules. We also investigate the allowed discretion in the year before and after auditor changes that involve the adoption of rotation rules (the low client-specific knowledge effect) and find evidence of lower audit quality in both years. This finding stands in stark contrast to the empirical evidence from voluntary audit changes using U.S. data (DeFond and Subramanyam

1998) and from mandatory changes using Belgian data (Vanstraelen 2000). These results highlight the importance-particularly to audit market regulators-of considering ways to mitigate the erosion of audit quality during the transition to new auditors under rotation rules; for example, the use of detailed handover files between predecessor and successor audit firms or two auditor involvement in years of initial audits (i.e., "four eyes concept"). I would like to note that depending on the statistic investigated, the benefit to audit quality (of adopting rotation rules) appears to be larger by a factor of at least two (some cases higher) than the costs of audit quality erosion at the forced rotation audit engagements.

In closing, I applaud you and others (particularly those in Brussels) for taking on the very important issue of the potential costs and benefits of adoption of rotation rules. I also appreciate the opportunity to speak with you about this issue and my research.