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Only Fools Rush In: Mandatory Audit Firm Rotation and the PCAOB

I. INTRODUCTION

In 2000, Enron Corporation’s reported net income was an impressive $979 million¹ and it allegedly produced $5.3 million in revenues per employee.² Given these seemingly fantastic figures, David Rynecki, writing on behalf of Fortune Magazine, declared Enron one of the “10 stocks to last the decade.”³ However, little more than a year passed before Fortune’s prophesy proved to be horribly wrong.⁴ On December 2, 2001, Enron filed for bankruptcy,⁵ and approximately one year later, USA Today estimated the sizable damage—over $63 billion in losses—to shareholders since Enron’s bankruptcy filing.⁶ Enron’s stock, once worth $83 per share, was worth a trifling 67 cents per share just over a year later, a decrease in value of approximately 99.2%.⁷ As Glenn Harlan Reynolds, a law professor at the University of Tennessee described the situation, “‘[i]t was not the end of innocence. It was the chastening of stupidity . . . people should have known better.’”⁸ Similarly, two commentators aptly analogized that “Enron sank like the

¹ The Enron Scandal by the Numbers, USA TODAY, Jan. 21, 2002, at B3 [hereinafter USA TODAY], available at http://www.usatoday.com/money/energy/2002-01-22-enron-numbers.htm (providing estimates of various matters relating to the “Enron scandal” including change in stock prices, company ranking and other descriptive figures).
⁵ Id.
⁶ USA TODAY, supra note 1.
⁷ USA TODAY, supra note 1.
⁸ Grier, supra note 4.
Titanic."⁹

In the wake of Enron, the public and Congress began to question whether auditor independence, as it stood, could be relied upon to ensure the accuracy of public company financial statements.¹⁰ They were concerned that allowing audit firms to provide other non-audit services to clients, especially consulting services, may undermine auditor independence.¹¹ As commentators argued, "an economic bond" cements between the auditor and its client when the auditor performs lucrative non-audit services, like consulting, for its client.¹² In the case of Enron, it compensated its accounting firm, Arthur Andersen LLP, for consulting and auditing services, paying Andersen $27 million and $25 million for these services, respectively.¹³ When the tawdry details of Enron’s accounting practices were revealed, reformists emphasized the need to prevent auditors from also providing consulting services to clients.¹⁴ This reformist concern was consistent with some earlier criticisms, which noted that when an audit firm receives significant revenues from a client for performing nonaudit services, the fear of losing these funds undermines auditor independence and professional skepticism.¹⁵

Witnessing the turmoil created by the fall of Enron, the House of Representatives investigated ways to increase the oversight of the accounting industry and to protect future shareholders from similar losses.¹⁶ Ultimately, Congress adopted "[a]n Act to protect investors by

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11. See id.


14. See id.

15. See Lindberg & Beck, supra note 12, at 37.

improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes” (Sarbanes-Oxley) to more closely regulate corporate audits.\(^ {17}\) The creation of the Public Company Accounting Oversight Board (PCAOB or Board) was the prominent feature of Sarbanes-Oxley, with its duty to “protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports” through its powers as a public regulatory organization.\(^ {18}\) However, Sarbanes-Oxley also required the Government Accounting Office (GAO) to investigate the wisdom and viability of mandatory audit firm rotation (MAFR) and to provide Congress with its findings by July 30, 2003.\(^ {19}\) MAFR, at its simplest, would require “a limit [to be placed] on the period of years in which a particular registered public accounting firm may be the auditor of record for a particular issuer.”\(^ {20}\) In the late summer of 2011, the PCAOB renewed the discussion of MAFR by requesting public comment on the potential effects of such a requirement on the auditing industry and public companies.\(^ {21}\) The comment period was extended by the PCAOB to November 19, 2012.\(^ {22}\) The PCAOB does not expect to undertake additional regulation, if any, until 2013.\(^ {23}\) Thus, the accounting industry and the public companies they serve are left in an

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uneasy standstill—will the PCAOB choose to implement MAFR, and if so, what would the ramifications be to the accounting industry and public companies?

This paper addresses these questions and asserts that MAFR should not be undertaken without additional research into the effects of MAFR, culminating in a more measured and critical examination by the PCAOB and accounting industry of MAFR's costs and benefits. Part II of this paper discusses the purpose of auditors and the history of MAFR. Part III addresses the PCAOB's August 2011 Concept Release, which seemingly reinvigorated the public discourse on the costs and benefits of implementing MAFR. This Concept Release is the first stage of the process the PCAOB uses in creating new standards. Part IV examines the proposed theoretical benefits of MAFR and contrasts these with the overwhelming costs associated with the implementation of MAFR. Finally, Part V provides a brief overview of some of the proposed alternatives to MAFR.

II. THE ROLE OF AUDITORS AND THE HISTORY OF MAFR

A. The Role of Auditors

Understanding the role of the corporate auditor is necessary to determine whether MAFR should be implemented. Auditors are independent accounting professionals whose purpose is to ensure that the information provided to the public by the management of public companies is a thorough and accurate reflection of each company's business affairs. The fundamental goal of the audit is to provide the public with a reliable assessment of the company's financial position.
To achieve these ends, three requisite characteristics of the auditor are frequently cited: "independence, objectivity, and professional skepticism." Even in early auditor accountability discussions during the 1970s, it was generally assumed that the public expected accountants to take an active role in critically examining financial statements of companies, to promote truthful financial disclosure, and to "exert surveillance over management." In fact, many people perceived fraud detection, in itself, to be one of the key purposes of corporate audits. Public perception of reliability is important because investor confidence declines when "users of the financial statement information do not perceive that the auditor was independent in appearance."

As Representative Oxley described in his testimony before the Committee on Financial Services in 2002, creating a public company regulatory system which bolsters public confidence in corporate financial statements is integral to a well-functioning marketplace. Auditors are expected to truly be "public accountants," protecting the people from corporate malfeasance by performing their oversight duties to "the highest standards of competence, independence, and ethical conduct."

B. The History of MAFR

Congressional concerns regarding auditor independence and the truth of corporate financial statements date back to the 1970s. Why,
then, has it taken over three decades for MAFR to be seriously considered as a method of regulating public company audits? Some suggest that the strong opposition from corporate Chief Financial Officers (CFO) underlies the delay, as MAFR "[causes CFO] blood to boil."\textsuperscript{38} The history of MAFR and the language of Sarbanes-Oxley suggest an equally plausible theory: Congress did not want to implement MAFR without adequately examining the benefits and repercussions of such regulations.\textsuperscript{39}

1. The 1970s, Growing Concerns Regarding Auditor Independence

In 1977, the Senate Subcommittee on Reports, Accounting and Management of the Committee of Government Operations published a staff study titled, "The Accounting Establishment," commonly referred to as the "Metcalf Report."\textsuperscript{40} Senator Metcalf, writing to the Chairman of the Senate Government Operations Committee, Abraham Ribicoff, discussed the "continual revelations of previously unreported wrongdoing by major corporations, as well as a series of corporate failures and financial difficulties" as the impetus for the subcommittee's study.\textsuperscript{41} In the study, the Committee encouraged Congress to evaluate various ways to foster competition among audit firms, particularly when vying for hire by large companies.\textsuperscript{42} The study continues:

Long association between a corporation and an accounting firm may lead to such close identification of the accounting firm with the interests of its client's management that truly independent action by the accounting firm becomes difficult. One alternative is mandatory change of accountants after a given period of years, or after any finding by the SEC that the

\textsuperscript{38} Hoffelder, supra note 23.


\textsuperscript{40} See Metcalf Report, supra note 37, at III.

\textsuperscript{41} Id.

\textsuperscript{42} See id. at 21.
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accounting firm failed to exercise independent action to protect investors and the public.\textsuperscript{43}

However, aside from this limited discussion and foreshadowing of MAFR proponents’ arguments, the Committee made no substantial recommendations regarding the viability of MAFR.\textsuperscript{44}

2. The Involvement of the Accounting Industry and the Report of the Cohen Commission

At the time the Metcalf Report was published, the American Institute of Certified Public Accountants (AICPA) had already created its own auditing oversight commission.\textsuperscript{45} The Cohen Commission served two fundamental purposes: (1) examining the duties of independent auditors; and, (2) determining whether there is a difference between the scope of these duties and the public’s perception of the scope of these duties.\textsuperscript{46} Although its members began meeting in 1974, a final report from the Commission was not made available until 1978.\textsuperscript{47}

However, even prior to the publication of the Cohen Commission’s findings, Congress expressed its skepticism about the neutrality of the Cohen Commission.\textsuperscript{48} As the Metcalf Report notes, “[I]ike the previous AICPA study groups, the Cohen commission is comprised entirely of representatives from large accounting firms, large law firms, large investment firms, large corporations, and academic accountants, some of whom have ties to the ‘Big Eight.”\textsuperscript{49}

Additionally, the Metcalf Report reiterated its concern that the Cohen Commission was funded by the AICPA, an obvious advocate for auditing firms.\textsuperscript{50}

\textsuperscript{43} Id.
\textsuperscript{44} Id.
\textsuperscript{45} See Cohen Commission Report, supra note 32, at xi.
\textsuperscript{46} See id.
\textsuperscript{47} Id.
\textsuperscript{48} See Metcalf Report, supra note 37, at 119.
\textsuperscript{49} Id.
\textsuperscript{50} See id. Though the Metcalf Report makes an important point regarding the potential for bias in the Cohen Commission’s report, alternatively, these industry representatives were also likely some of the most capable persons to analyze auditor accountability, given their positions in major firms and their breadth of accounting knowledge and experience.
Nonetheless, in its report, the Cohen Commission highlighted the importance of "an independent audit" due to the "inherent potential conflict between the entity’s management and the users of financial information." Similarly, the Commission emphasized that when done properly, an audit ensures that corporate managers have conformed to their responsibilities. After reviewing the concept of MAFR, the Cohen Commission argued that MAFR’s benefits would be counteracted and outweighed by the costs of such a regulatory scheme. Additionally, the Commission posited that the gains of rotation are more easily and economically attainable, simply by rotating the audit employees assigned to a particular client company, with such employment subject to the constant oversight and management discretion provided by the audit committee of the client company’s board of directors.

3. Sarbanes-Oxley

To protect shareholders and manage the economic fallout of the Enron scandal, in 2002 Congress decided that “important changes” were necessary to safeguard auditor independence and reliable financial reporting, as such concerns “have percolated for some time [and] . . . . the bankruptcies of Enron, Global Crossing, and others have pushed them to the forefront.” Accordingly, in the House of Representatives, Representative Oxley sponsored and advocated for the Corporate and Auditor Accountability, Responsibility, and Transparency Act of 2002 (or CAARTA). CAARTA offered a variety of provisions to increase auditor independence. Among them, the U.S. Securities and Exchange Commission was tasked with reviewing accountants issuing certain types of financial statements and with the responsibility of creating a public regulatory organization to promulgate accounting rules, enforce securities laws and regulations, and review audit firms for

52. See id.
53. See id. at xxx, 108-09.
54. See id.
55. Accounting Regulatory Overhaul, supra note 16.
56. Id.
auditor independence.\textsuperscript{58}

When CAARTA was discussed before the House Financial Services Committee, Representative Oxley proposed major changes in federal securities laws to "[enhance] the public’s faith in financial statements," while remaining balanced and "[avoiding] the temptation some apparently feel to blanket market participants in a sea of red tape."\textsuperscript{59} Instead, Representative Oxley highlighted the Committee’s choice to address auditor accountability concerns in a more measured fashion.\textsuperscript{60}

In his remarks, Representative Oxley particularly emphasized the testimony of then-Federal Reserve Chairman Alan Greenspan, and reiterated "the markets’ self-correcting mechanism . . . underscore[s] the danger of overreacting to the Enron matter."\textsuperscript{61} However, he endorsed change to protect investment, as "America does not tolerate cheats."\textsuperscript{62} Despite CAARTA’s steps toward greater auditor oversight, some, like the \textit{Washington Post} in its editorial "Mr. Oxley Punts," were critical that provisions for mandatory audit firm rotation were absent from the reforms posed by CAARTA.\textsuperscript{63}

Meanwhile, the Senate examined ways to reform the accounting industry, with the goal to promote auditor independence and objectivity.\textsuperscript{64} The Senate’s initiative, spearheaded by Senator Sarbanes, resulted in the Senate Committee on Banking, Housing, and Urban Affairs drafting of the Public Company Accounting Reform and Investor Protection Act of 2002 (Act).\textsuperscript{65} Among other things, this Act required the Comptroller General to complete a study of the costs and benefits of implementing MAFR.\textsuperscript{66} A call for research of MAFR

\textsuperscript{58.} \textit{Id.}
\textsuperscript{59.} \textit{Accounting Regulatory Overhaul, supra note 16.}
\textsuperscript{60.} \textit{See id.}
\textsuperscript{61.} \textit{Id} (emphasis added).
\textsuperscript{62.} \textit{Corporate Accounting and Disclosure Rule Revision: Hearing on H.R. 3763, Corporate Auditing Accountability, Responsibility, and Transparency Act (CAARTA) Before the H. Comm. on Fin. Serv., 107th Cong. 2 (March 20, 2012).}
\textsuperscript{63.} \textit{See Editorial, Mr. Oxley Punts, WASH. POST, Apr. 24, 2002, at A28 (analyzing CAARTA provisions).}
\textsuperscript{64.} \textit{See S. REP. No. 107-205, at 1 (2002) (discussing auditor accountability and financial statement reliability to further explain S. 2763 107th Cong. (2002), the senate bill discussing the same issues).}
\textsuperscript{65.} \textit{S. 2673, 107th Cong. § 2, 77 (2002).}
\textsuperscript{66.} \textit{Id.}
ultimately became part of Sarbanes-Oxley.\textsuperscript{67}

In addition to initiating the GAO study and creating the PCAOB, Sarbanes-Oxley implemented mandatory audit partner rotation.\textsuperscript{68} Conceptually similar to MAFR, audit partner rotation prevents an audit partner from overseeing a company's audit if the partner has worked on the company's audit anytime in the prior five fiscal years.\textsuperscript{69}

\section*{4. The GAO Report}

The research performed by the General Accounting Office (GAO) in 2003 and provided to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services ultimately determined that MAFR "may not be the most efficient way to strengthen auditor independence and improve audit quality."\textsuperscript{70} In reaching this conclusion, the GAO divided its investigation into three areas.\textsuperscript{71} First, the GAO examined previous research relating auditor independence and audit quality for an audit engagement to the audit firm's tenure on the engagement.\textsuperscript{72} This research included studies which examined the potential pros and cons of implementing MAFR.\textsuperscript{73} Second, the GAO used its findings from reviewing prior research to actively engage industry participants in discussion and analysis of the costs and benefits of MAFR.\textsuperscript{74} In particular, the GAO: (1) created its own questionnaires to distribute to audit firms, chief financial officers, and audit committee chairs,\textsuperscript{75} (2)
facilitated discussions with “interested stakeholders” regarding MAFR, and (3) examined MAFR as implemented in other countries. Finally, the GAO examined Fortune 1000 companies’ financial restatements arising from “errors or fraud.” The purpose of this analysis was twofold: (1) to document if restatements of company’s financial statements were more common when company’s engaged a new audit firm, and (2) to determine whether any increase in restatement filing is attributable to a “fresh look” by the new audit firm at the company’s financials.

The majority of survey respondents in the subgroups examined and “other knowledgeable individuals” indicated that the benefits attributed to MAFR will be obtained through the reforms already required by Sarbanes-Oxley and the SEC, namely audit partner rotation. The GAO argued that prior to implementing MAFR, the results of the already enacted requirements of Sarbanes-Oxley should be examined by the SEC and PCAOB. As the GAO notes, the SEC and PCAOB need to give these reforms sufficient time to be implemented and examined in order to make an informed decision about whether additional reform, such as MAFR, is required to secure audit quality.

The GAO emphasizes the importance of efficiency, highlighting that other reforms, including those already in place, may have effects similar to those under an MAFR regime without the additional MAFR costs. The PCAOB itself admits in its Concept Release regarding MAFR that “the Board believes that the reforms in the Act have made a significant, positive difference in the quality of public company auditing.” Additionally, the GAO provides a refreshing dose of realism noting that MAFR “is not a panacea that totally removes the pressures on auditors.”

insufficient participation, the GAO ultimately relied on the survey results from one subgroup for its study, a group containing 201 responses from 330 Fortune 1000 (a 60.9% response rate). Id. at 2-3. Id. at 3-4. U.S. Gov’t Gen. Accounting Office, supra note 19, at 3. Id. at 5; see infra footnote 75 (providing more information on survey respondent classification).

80. Id.
81. See id. at 8.
82. Id.
84. U.S. Gov’t Gen. Accounting Office, supra note 19, at 8.
Cohen Commission, in the Sarbanes-Oxley hearings, and in the GAO report remain relevant to our current discussion of the wisdom of implementing MAFR.

III. THE PCAOB'S 2011 MAFR CONCEPT RELEASE

The PCAOB was established by the Sarbanes-Oxley Act:

to oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors.\(^\text{85}\)

In addition, the PCAOB is charged with the duty to "establish or adopt, or both, by rule, auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers."\(^\text{86}\)

The PCAOB requires that all accounting firms which provide audit reports to public companies register with the Board.\(^\text{87}\) The Board annually inspects audit firms that audit over 100 public companies.\(^\text{88}\) In 2011, the PCAOB reviewed 340 audits across 10 firms which met the PCAOB's requirement for annual inspections.\(^\text{89}\) Firms which do not meet the criteria for annual inspection are inspected, at minimum, once every three years.\(^\text{90}\) The Board also investigates certain auditors which are auditing entities located abroad.\(^\text{91}\)


\(^{87}\) See 2011 Annual Report, supra note 26, at 4 (discussing the duties of the PCAOB and reviewing the agency's involvement overseeing audit firms in the past year).

\(^{88}\) Id.

\(^{89}\) Id.

\(^{90}\) Id. at 5.

\(^{91}\) Id. at 7.
The PCAOB’s inspection of audit firms is multifaceted, with the Board reviewing parts of the firm’s work product, its quality control system, and its adherence to standards of professional conduct and other rules and laws. In determining which subset of audits to inspect, the Board takes a holistic approach, examining many factors including the character of the firm and the Board’s findings in previous inspections of this auditor. After creating a report summarizing the investigation, the Board releases certain information regarding the investigation to the public, while allowing the audit firm one year to privately correct issues with the audit discovered by the Board. If the Board finds an audit firm violated an obligation, it may also discipline the firm; penalties include barring an audit partner from practicing or fining the firm.

MAFR is a particular concern for the PCAOB because of the “significant inherent risk” associated with asking audit firms to independently examine their income source, the client. The PCAOB fears that auditors will be unable to make the difficult choice between their responsibility to shareholders and the pressures exerted by management of the public company, particularly noting that an auditor may be unaware of her predisposition to favor management. In fact, the PCAOB suggests that these relationships may already be causing adverse effects on audits, as the PCAOB has mounting concerns regarding “both the frequency and the type of audit deficiencies” it encounters during the course of its inspection duties. In particular, the PCAOB has found evidence during its inspections that it believes reveals a decline in auditor objectivity and independence in evaluating clients. To summarize, the PCAOB is concerned with the risk of conflicts of interest existing when client companies pay audit firms to evaluate them and when lengthy audit firm tenures are used as “long-term income stream[s].” The PCAOB suggests that these issues result in decreased auditor independence, and as a result, lesser audit

92. See id. at 5.
93. See 2011 Annual Report, supra note 26, at 5.
94. See id.
95. See id. at 18.
97. See id. at 9.
98. Id. at 5.
99. See id. at 2.
100. See id. at 4, 9.
Although the PCAOB expressed its desire for comment from the public regarding MAFR, it openly asserted its opinion that MAFR could increase auditor accountability. The PCAOB’s method of presentation of the MAFR discussion, in itself, provides an indication that the Board is strongly considering the implementation of MAFR requirements. However, the PCAOB is not the only organization with an opinion on the matter; in response to the PCAOB’s comment request, the Board received nearly seven hundred statements over the course of approximately a year. The sheer volume of the response to the Board’s Concept Release suggests the need for careful study and reflection on the costs and benefits of MAFR prior to implementation of a regulatory scheme to implement MAFR.

IV. THE THEORETICAL BENEFITS, AND THE UNDENIABLE COSTS, OF MAFR

A. The Speculative Benefits of MAFR

Though a variety of arguments have been posed in favor of MAFR over the years, three arguments, in particular, warrant further discussion: (1) the “fresh eyes/fresh look” argument; (2) the “auditor coziness” argument; and, (3) the “watchdog” argument. Although presented as distinct arguments, an underlying and relatively simple premise seems to run through each: new auditors are more independent and critical of public companies than current auditors.

101. See id. at 2, 5.
105. See id. at 15.
106. See e.g. Accounting Reform and Investor Protection Issues Raised by Enron and Other Public Companies: Hearings Before the S. Comm. on Banking, Hous., and Urban Affairs, 107th Cong. at 347-48 (2002) (statements of John Biggs, President of TIAA-CREF) [hereinafter Accounting Reform and Investor Protection] (indicating that Arthur Andersen, the accountant for Enron, would have been more likely to challenge management regarding accounting practices and would have had more incentive to thoroughly document deals if it knew another auditor would be reviewing the audit in the near future. Biggs testimony is an exemplar of the watchdog argument.).
1. Seeing the Audit through “Fresh Eyes”

The Cohen Commission report, though it did not endorse MAFR, recognized that one of the main arguments cited in favor of MAFR is that it would usher in “a fresh viewpoint[...]” to review the public company.\textsuperscript{107} Similarly, the 2003 GAO report to Congress regarding MAFR stated that when certain negative trigger factors exist suggesting potential auditor impropriety, audit committees “need to be especially vigilant in the oversight of the auditor and in considering whether a ‘fresh look’ (e.g., new auditor) is needed.”\textsuperscript{108} The GAO cites a 2003 report by the Conference Board Commission on Public Trust and Private Enterprise supporting this position and outlining trigger factors which should spawn voluntary rotation.\textsuperscript{109} In discussing the merits of MAFR, the Conference Board Commission touts several benefits of voluntarily rotating audit firms, noting that firm rotation allows for candid evaluation of three key areas: (1) the financial reports of the public company; (2) the accounting procedures utilized by the public company; and, (3) the audits and associated materials actually performed by the prior audit firm.\textsuperscript{110} The specific trigger factors which might warrant such a review by the audit committee include, as follows:

(1) the audit firm has been employed by the company for a substantial period of time – e.g., over 10 years; (2) one or more former partners or managers of the audit firm are employed by the company; and (3) significant non-audit services are provided to the company – even if they have been approved by the audit committee.\textsuperscript{111}

According to the Conference Board Commission, after examining these conditions, and potentially others, the audit committee may believe that rotation of the audit firm would bolster shareholder’s

\textsuperscript{107} Cohen Commission Report, \textit{supra} note 32, at 108.
\textsuperscript{108} U.S. GOV’T GEN. ACCOUNTING OFFICE, \textit{supra} note 19, at 9.
\textsuperscript{109} See U.S. GOV’T GEN. ACCOUNTING OFFICE, \textit{supra} note 19, at 9.
\textsuperscript{111} \textit{Id.} at 33-34.
perception regarding the validity of the company’s financial statements and the audit.\(^{112}\)

The “fresh-eyes” argument has been studied, to some extent, in the real world.\(^{113}\) As the GAO notes in its report to Congress, the forced dissolution of Arthur Andersen, LLP in 2002 led to other Tier 1 firms taking over the audit responsibilities of approximately 1,200 public companies.\(^{114}\) Examining various SEC forms and subsequent restatements of the applicable subgroup reviewed by the study, the GAO determined that among the selected companies, the restatement rates resulting from “errors or fraud” after hiring a new audit firm totaled “10.7% in 2001 and 3.9% in 2002.”\(^{115}\) Conversely, companies which did not rotate their audit firm experienced restatement rates of “2.5% in 2001 and 1.2% in 2002.”\(^{116}\) Though the GAO offers this data as potentially persuasive research showing that “fresh look[s]” really do uncover mistakes and fraud under a MAFR-comparable scenario, the GAO stops short of making such a resounding conclusion.\(^{117}\) In fact, it specifically highlights that the change in the percentage of restatements observed may be due to the “fresh look” or an array of other factors.\(^{118}\) Without further research, it is impossible to specifically identify the reasons for the restatements.\(^{119}\)

2. The Perils of “Auditor Coziness”

During the committee hearings for CAARTA, concerns over auditor coziness between Enron and Arthur Andersen were made a major focus in the testimony of then-Chairman of the U.S. Securities and Exchange Commission Harvey Pitt.\(^{120}\) For example, Representative Ney posed the following question:

\(^{112}\) See id.
\(^{113}\) See U.S. GOV’T GEN. ACCOUNTING OFFICE, supra note 19, at 46.
\(^{114}\) Id.
\(^{115}\) Id. at 46-47.
\(^{116}\) Id.
\(^{117}\) Id. at 47.
\(^{118}\) Id.
\(^{119}\) See U.S. GOV’T GEN. ACCOUNTING OFFICE, supra note 19, at 47.
\(^{120}\) See Accounting Standards and the Enron Collapse: Panel I of a Hearing of the House Financial Services Committee, 107th Cong. 12 (2002).
Mr. Pitt, could you give your view on how accounting firms maintain their independence of their auditors when members of their firm work for years with the same company? And what I’m trying to get at is a question I had asked in an earlier hearing a few weeks ago, I raised the issue about how Andersen employees were intertwined with Enron. They were actually mistaken for Enron employees. They even went as far as to wear Enron golf shirts and went on Enron retreats. And some of the people thought they were Enron employees. So, could you tell us, in your opinion, if the reforms proposed in H.R. 3763 or the reforms you suggested will ensure independence of future auditors—not just with golf shirts, but, you know, mistaken identity?  

Similarly, in its Concept Release the PCAOB points to the testimony of the Investor Advisory Group (IAG) highlighting that one of the greatest threats to the independence and professional skepticism of an auditor is the degree of “coziness” exhibited between firm management and the independent auditor. In support of its assertion, IAG stated that many of the major companies associated with financial scandals had remained with the same audit firm for extensive periods of time. The GAO found that, on average, Fortune 1000 public companies retain their auditors for approximately twenty-two years.  

It is argued that lengthy audit firm engagement may also create an environment where the auditor feels pressure to please the client. Long audit tenure is like an annuity which offers up a consistent source of future income—the prospect of losing this income stream, it is
argued, may undermine auditor independence and professional skepticism. Given the often substantial tenure of audit firms with particular clients, this concern over auditor coziness has been cited as potentially "the most compelling argument in favor of audit firm rotation." \(^{128}\)

3. The "Watchdog" Argument

In discussing auditor independence, the PCAOB cites the U.S. Supreme Court's discussion of the auditing profession and the Court's assertion that independent auditors function as a "public watchdog." \(^{129}\) A similar "watchdog" type argument is discussed in relation to MAFR, when commentators suggest that indicia of auditor independence increase when accountants fear being criticized by another auditor for doing allegedly erroneous or fraudulent work. \(^{130}\) As John Biggs, President of TIAA-CREF, described to the Senate during its hearings post-Enron, the expectation that an auditor's work is going to be reviewed in the near future by a competitor can provide the needed "bite" to curb potential auditor misbehavior. \(^{131}\)

Had Arthur Andersen in 1996 known that Peat Marwick was going to come in in 1997, there would have been a very different kind of relationship between them and Enron. Clearly, they would have wanted to have their work papers in order, all of the deals documented and well explained. They might well have challenged Enron's management in that early period where Enron was changing its accounting. . . . I would think that there is a very high probability that had rotation been in place at Enron with Arthur Andersen, you would not have had the accounting scandal that I think we have now . . . . \(^{132}\)

\(^{127}\) Id.

\(^{128}\) Id.


\(^{130}\) See Accounting Reform and Investor Protection, supra note 106, at 347-48.

\(^{131}\) Id. at 348.

\(^{132}\) Id. at 347-48.
This “watchdog” theory has garnered some academic support. A 2006 study found that auditors are more likely to report a material misstatement against the client’s wishes when audit rotation is pending than when the auditor relationship is ongoing and not constrained by MAFR.\textsuperscript{133} However, caution should be used when relying on this study due to its experimental design. Rather than examining how auditors reacted in past real-life scenarios, the study asks its CPA subjects to “estimate” how their firm would respond if the experiment were real.\textsuperscript{134} Common sense indicates that “estimating” how an auditor would respond to a conflict of interest is not the same as seeing how the auditor actually responded to a conflict. Accordingly, this study should be given limited weight by regulators in evaluating the empirical underpinnings of the watchdog argument.

B. The Recognized Costs of MAFR: The General Arguments Against Implementation

There are three general arguments posed by the AICPA and Center for Audit Quality (CAQ), an independent advisory group against implementation of MAFR.

First, as the AICPA highlights, the PCAOB emphasizes auditing errors it uncovered in accordance with its auditor inspection and review duties,\textsuperscript{135} but then it (the PCAOB) never actually provides a causal connection between the audit failures identified and “a lack of auditor objectivity and professional skepticism.”\textsuperscript{136} This concern over a missing causal link or understanding of the “root cause” is echoed by the CAQ, which spoke out against MAFR in its public comment letter to the PCAOB.\textsuperscript{137}

\textsuperscript{133} See Barbara Arel et al., Findings on the Effects of Audit Firm Rotation on the Audit Process Under Varying Strengths of Corporate Governance, 22 ADVANCES IN ACCOUNTING 1, 2, 22 (2006).
\textsuperscript{134} Id. at 2.
\textsuperscript{135} See PCAOB Release No. 2011-006, supra note 21, at 5.
Second, as the AICPA implies in its letter, there is a distinct difference between identifying problems or concerns with auditor independence and identifying solutions to those problems. The AICPA, likely expressing the view of many in the industry, argues that MAFR is not at present the solution to the obstacles preventing optimum auditor “independence, objectivity and professional skepticism.” In its letter to the PCAOB, the AICPA advocates for the Board to show reliable empirical evidence linking MAFR to improved audit quality, particularly evidence capable of overcoming several studies of MAFR which suggest that “mandatory firm rotation may have an adverse impact on audit quality.” The CAQ provides a concise summary of the problem, as follows:

While we are wholly committed to improving audit quality, we do not see any evidence that MAFR would result in direct and measurable improvements in audit quality, and we believe that such a mandate would have far-reaching, costly, and unintended consequences, not only for auditors and audit firms, but for public companies, audit committees, and investors.

Third, before implementing additional rules, it is sensible for the PCAOB to examine the current rules and regulatory system for their overall effectiveness—how else can you determine if the newest reforms improved the regulatory system? For instance, the CAQ points out that, beginning in July 2009, the PCAOB promulgated nine “significant new professional standards that are likely to have an important effect on audit quality,” but has yet to decide if there is still a problem and to evaluate the effectiveness of recent reforms. Additionally, the Board’s 2011 audits under these new standards had yet

139. Id. at 1-2.
140. See id.
141. Id. at 6 (emphasis added).
142. Letter from the Ctr. for Audit Quality, supra note 137, at 8-9.
144. Letter from the Ctr. for Audit Quality, supra note 137, at 8.
to start at the time public comment began on MAFR. The PCAOB needs to adequately address these general concerns prior to implementing MAFR regulations.

Other nations have implemented MAFR schemes, among them Italy, India, Brazil, Singapore, and Spain. Examining the effects of MAFR in Spain from 1988 to 1995 provides a helpful case study for predicting the costs and benefits of MAFR implementation in the United States.

Spain repealed MAFR less than a decade after its implementation. When comparing auditor independence during the MAFR period to the five years immediately thereafter (years 1995 to 2000) for 1,326 “financially distressed” clients, researchers concluded there was “no evidence” indicating that auditors were more inclined to provide a qualified audit opinion during the MAFR period. Additionally, the audit “annuity” argument expressed by proponents of MAFR did not come to fruition in Spain—researchers determined that there was not a “signification association” linking auditor independence to the “economic dependence” of the auditor to the client, regardless of whether examining the MAFR period or the unregulated period.

Perhaps even more interesting is the researcher’s conclusion that in reality, MAFR may actually decrease an auditor’s desire to strive for a reputation for audit quality and auditor independence. The researchers believe this result occurred because traditional “market-based mechanisms,” which previously encouraged auditors to foster reputations for quality, lose effectiveness when MAFR is implemented. The researchers summarize that in the MAFR program

145. Id. at 8.
147. Id. at 114-15.
148. Id. at 115.
149. Id.
150. Id. at 116.
151. See Audit Firm Rotation and Audit Quality, supra note 126, at 36, 38 (see infra p. 20 for previous discussion of the annuity argument).
152. Ruiz-Barbadillo et al., supra note 146, at 116.
153. See id. at 132.
154. See id.
implemented in Spain “mandatory rotation not only fails to enhance auditor independence, but may in fact harm independence.” 155 Another study indicates that when there is a system of mandatory rotation auditors lose the motivation to promote an independent reputation because “rotation ‘drastically limits the possibility of economically realizing a substantial part of the reputational capital of the audit firm.’” 156 Thus, the empirical analysis of Spain seems to run directly counter to the “watchdog argument” of MAFR proponents; 157 auditors operating under MAFR regulations are/appear less concerned with reputation. 158

C. The Recognized Costs of MAFR: The Specific Arguments Against Implementation

1. MAFR undermines the power of the Audit Committee

One of Congress’s chosen methods of protecting auditor independence was through its mandate that public companies each create an audit committee to choose the appropriate auditor for its company. 159 As the AICPA argues, 160 and as the language of Sarbanes-Oxley plainly states, Congress chose to place the “appointment, compensation, and oversight” of the audit firm squarely within the hands of the audit committee, rather than making an outright mandate of auditor rotation. 161 Additionally, these auditors are required to be independent, based on criteria provided in Sarbanes-Oxley, including restrictions on compensation of audit committee members and prevention of members being “an affiliated person of the issuer or any subsidiary thereof.” 162 The AICPA suggests that the audit committee, in addition to examining qualities of an audit firm like “reputation” and

155. Id.
156. Id. at 113, 117 (citing Arruñada, B., and C. Paz-Ares, Mandatory Rotation of Company Auditors: A Critical Examination, 17 INT’L REV. OF L. AND ECON. 31, 55-56 (1997)).
158. See Ruiz-Barbadillo et al., supra note 146, at 132.
160. See id.
162. Id.
"industry experience," should consider the firm's tenure with the company when evaluating the appropriate audit firm for the company.\textsuperscript{163} The AICPA asserts that the audit committee should be allowed to perform as Congress intended.\textsuperscript{164} However, MAFR would inhibit the audit committee’s discretion in choosing the most suitable audit firm for the company’s needs.\textsuperscript{165}

Concerns regarding the role of the audit committee are shared by others in the field. The GAO emphasized the importance of the audit committee\textsuperscript{166} in explaining why MAFR "may not be the most efficient way to strengthen auditor independence and improve audit quality."\textsuperscript{167} As the GAO stated:

\begin{quote}
We also believe that if audit committees regularly evaluated whether audit firm rotation would be beneficial, given the facts and circumstances of their companies' situation, and are actively involved in helping to ensure auditor independence and audit quality, \textit{many of the benefits of audit firm rotation could be realized at the initiative of the audit committees rather than through a mandatory rotation requirement.}\textsuperscript{168}
\end{quote}

It is critical that the PCAOB not implement regulatory schemes which would hinder the intent of Congress in providing oversight power to individual audit committees.

2. MAFR will lead to the appointment of less-qualified, less-expert, or less experienced audit firms

Depending on the type of audit required, particularly in certain geographic locations, finding a suitable audit firm may become incredibly difficult under MAFR, if not impossible, due to the limited

\begin{footnotes}
\item[164] See id.
\item[165] See id.
\item[166] See U.S. GOV'T GEN. ACCOUNTING OFFICE, supra note 19, at 9.
\item[167] Id. at "What GAO Found."
\item[168] Id. at 9 (emphasis added).
\end{footnotes}
number of proficient firms. Additionally, companies that require specialized audits may currently incur significant costs finding appropriate audit firms, which would likely be exacerbated under MAFR if firms cease specialized operations for lack of business under a rotation regime. For example, a survey completed by the Business Roundtable found:

[all] of the companies responding to our Survey noted that they engage one of the Big Four audit firms for auditing services. Nearly all of the companies responding to our Survey indicated that they would have difficulty finding a replacement audit firm with an absence of independence issues, sufficient geographic presence, and the necessary expertise to replace their current auditor, with nearly sixty percent noting that it would involve "significant difficulty."

The CAQ also highlights these concerns noting that MAFR, when imposed on the already inherent structural difficulties audit committees face finding suitable audit firms, might in reality have the opposite effect of what the PCAOB desires. Instead of promoting a high quality audit, CAQ argues that the actual result may be that the auditing industry is unable "to develop and retain specific competencies such as industry expertise." As one commentator noted, the problem of finding an adequate auditor will be greatest for those companies in "a niche industry . . . [with] a global reach."

This sentiment is echoed by the Independent Directors Council (IDC) regarding the audit of investment funds, one such niche

170. See id.
172. See Letter from the Ctr. for Audit Quality, supra note 137, at 9-10.
173. Id.
The industry. The IDC highlights that there are few firms that are sufficiently independent and proficient to effectively audit an investment fund. The IDC points to data which indicates that four accounting firms, as of December 2011, provide auditing services for 94% of funds, totaling approximately 99% of assets in the investment fund industry. It cautions that MAFR should not be used as a tool for allowing smaller firms to "compete" for the opportunity to audit fund financial statements because "these firms currently do not have the expertise and experience typically necessary to audit fund financial statements."

Additionally, the IDC argues that any assertions that these small firms could reach the necessary standards are "speculative" and would entail considerable costs to the company. Some academics have stressed a similar concern that "non-Big Four firms" may not only be lacking the skill necessary to perform extensive SEC audits, but also may not desire to take on the burdens of such an audit.

3. "Fresh eyes" encounter substantial "learning curves"

Audit quality may improve as the auditor's tenure increases. The AICPA touted one study which indicated that:

[A]udit quality "tends to improve rather than worsen with tenure, providing support to the expectation that there is a significant learning process for the auditor, i.e., an auditor needs time to get to know sufficiently well the business of the client and consequently, audit

176. Id.
177. Id. at 6.
178. Id.
179. Id.
180. See Audit Firm Rotation and Audit Quality, supra note 126, at 39.
quality tends to increase over time."182

For example, in a study analyzing the probability of fraudulent financial statements based on the length of auditor employment for a subset of New York Stock Exchange listed companies, research indicated that as audit firm tenure increases, the likelihood of fraudulent financial statements decreases.183 As the researcher noted, this finding undercuts arguments that lengthy audit tenure leads to increased fraudulent reporting.184 Other research also indicates that under our current system, lengthy audit tenure does not lead to declining earnings quality in financial reporting.185

In a review of Australian listed firms from 1995 to 2003 analyzing the actual quality of the audit (as opposed to the perceived quality of the audit),186 researchers determined that audit quality does not decline as audit firm tenure increases.187 As they describe it, [W]e conclude that there are minimal, if any, benefits of imposing mandatory audit firm rotation onto Australian firms. Further, given the costs involved in switching auditor, it does not appear that mandatory audit firm rotation would be beneficial to the market. In order to address the concerns that have arisen recently around auditor independence and audit quality, other initiatives are more likely to have a greater impact than imposing mandatory audit firm rotation.188

As the GAO noted in its 2003 study, it is important to remember

182. Id.
184. Id. at 10.
185. See James N. Myers et al., Exploring the Term of the Auditor-Client Relationship and the Quality of Earnings: A Case for Mandatory Auditor Rotation?, 780 THE ACCOUNT. REVIEW 779, 780-81 (July 2003) (arguing that earnings quality is related to audit quality and can be used as a metric for studying the effects of rotation).
187. Id. at 433.
188. Id. at 433-34.
that a new auditor’s learning curve “can last a year or more.” Additionally, where “matters of professional judgment” are involved as opposed to “actual errors,” the “fresh eyes” learning curve may result in new auditors behaving in “an overly aggressive manner” due to lack of institutional knowledge. Moreover, extreme learning curve difficulties may be encountered as the PCAOB seeks to impose a MAFR system on top of the current audit firm partner rotations system.

4. Increased auditing costs

The PCAOB admits in its concept release that growing “audit costs may be a consideration that merits particular discussion during a period of economic weakness and heightened global competition.” Estimating the cost of lost efficiency is difficult, although it is not unreasonable to assume that as new auditors are rotated into an unfamiliar company, this may lead to higher costs. These costs may include increased hours required of the client’s personnel, increased hours of the auditor, and generally more lengthy audit periods. Though estimates of the exact costs vary, one survey provided during the PCAOB’s public comment period by the Business Roundtable found that responding member companies that had experienced firm changes in the last decade had each accrued costs for such audit firm rotation estimated in a range from $500,000 to in excess of $5 million. Additionally, the GAO survey indicates that “[n]early all Tier 1 firms estimated that initial year audit costs under mandatory audit firm rotation would increase by more than twenty percent over subsequent year costs to acquire the necessary knowledge of the public company.” The GAO survey found that likely annual costs for public companies to locate potential auditors and provide “support” would account for approximately seventeen percent of the audit fees during the

190. Id.
194. See id. at 15.
new auditor’s first year of auditing the client. The AICPA echoes the concern that increased client costs would arise due to the screening process for potential audit firms and the education process for new audit firms regarding the company.

Further, there appears to be a reasonable fear of unintended costs of implementing MAFR arising from the insufficient research into the effects of implementation. Among the concerns, commentators suggest that clients who are suddenly forced to switch auditors may be lured to lower-quality auditors as “marketing ability [will] trump technical competence.”

Thus the actual result of MAFR may be the creation of forced periodic “bidding war[s]” between auditors, so-called “beauty contests.” These “beauty contests” will likely be characterized by behaviors regulators do not intend to encourage, for example, auditors underestimating auditing fees to obtain clients and clients “opinion shopping” for deferential auditors. So, increased competition may be sufficient to create “beauty contests” but insufficient to incentivize auditors to take a “true fresh look.” Without further research, unintended consequences may result from the hasty implementation of a MAFR scheme.

5. Rotation will likely not fix the “musical chairs among audit firms”

Richard Breeden, former Chairman of the U.S. Securities and Exchange Commission, has not taken a position on whether MAFR should be implemented, but he provided an interesting discussion on why MAFR may not be capable of substantially increasing auditor

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197. Id.
199. See Audit Firm Rotation and Audit Quality, supra note 126, at 38-39.
200. Id. at 39.
201. See Karim Jamal, Reviewing Rotation, CAMAGAZINE, June-July 2012, at 36, 37 (questioning whether MAFR will actually promote higher quality audits).
202. Id.
203. Id.
Breeden highlights the conflict auditing professionals face, striving both for integrity in their audits and to achieve financial security for themselves and their firms. He argues that these financial concerns will be expressed in two ways under a system of MAFR. First, auditors will be concerned during the beginning of their tenure with losing the audit engagement. Second, near the end of their engagement with the client, the current firm will be spread thinly, as they seek to secure a new client from the pool up for grabs under the rotation scheme that year. The result of this system, as Breeden sees it, is simple:

Ultimately, rotation would replace one set of somewhat conflicted partners with another set of partners with the exact same issue. One group of people would lose their relationship, while another group would step into their shoes and have the identical potential conflict. ... I really doubt that objectively levels would rise that much overall.

According to Breeden, unqualified objectivity, in itself, may be an impossible goal, as an auditor’s necessarily close relationship with a client naturally increases the likelihood that on marginal issues the auditor will side with the client.

V. ALTERNATIVES TO MAFR

The PCAOB’s concept release asked commentators to include their thoughts on alternatives to MAFR, although the release was clearly focused on the effects of MAFR. Commentators responded with

205. See id.
206. Id. at 5-6.
207. Id. at 6.
208. Id.
209. Id.
210. Id. at 6. See also, U.S. GOV’T GEN. ACCOUNTING OFFICE, supra note 19, at 6 ("Most Tier 1 firms and Fortune 1000 public companies believe that mandatory audit firm rotation would not have much effect on the pressures faced by the audit engagement partner in appropriately dealing with material financial reporting issues.").
211. See Statement from Richard C. Breeden, supra note 204, at 6.
several alternatives to MAFR, among them: a shareholder vote for the company's audit firm;\textsuperscript{213} the "comply or explain" model;\textsuperscript{214} the "insurance" model;\textsuperscript{215} and, the shift of emphasis to the audit committee.\textsuperscript{216} Others suggest a phase-in approach would be optimal, applying MAFR regulations only to select public companies, namely, (1) those that are "too big to fail" per FDIC designation and (2) every significant financial institution.\textsuperscript{217} Additionally, to address the "learning curve" problem, the concept of a "dual audit" has been floated—essentially, during the transition year between old and new auditors, the old audit firm and the new audit firm would be obligated to perform the audit and report its findings.\textsuperscript{218} Again, however, the viability of these alternatives requires further research. Some of the suggested models are described more fully, as follows.

A. Shareholder Vote

One alternative to MAFR is the "shareholder vote" model.\textsuperscript{219} Under a suggested version of this framework, shareholders would annually vote on the public company's auditor, with the "Big Four" audit firms all included on the ballot.\textsuperscript{220} Theoretically, this would allow shareholder's to oust firms they believe "see no evil" in the manager's potentially biased valuations in lieu of auditors that shareholders believe will accurately assess the health of the company.\textsuperscript{221}

\begin{itemize}
\item \textsuperscript{216} See Letter from the Ctr. for Audit Quality, \textit{supra} note 137, at 3.
\item \textsuperscript{217} See Charles A. Bowsher, \textit{Auditor independence and Audit Firm Rotation: Responses to the PCAOB's Concept Release}, 82 CPA J. 6, 8 (May 2012).
\item \textsuperscript{218} Id.
\item \textsuperscript{219} Id.
\item \textsuperscript{220} See generally Latham, \textit{supra} note 213.
\item \textsuperscript{221} Id.
\end{itemize}
B. Comply or Explain Model

In examining the "possible middle ground" between no change to the current regulatory scheme and the implementation of MAFR, the former Chairman of the SEC, Richard C. Breeden, suggests adoption of the "comply or explain" model.222 As he describes it, the PCAOB would implement a rebuttable presumption that at the end of a set time period the audit committee must choose a new audit firm ("comply") unless it can justify to the PCAOB why the current auditor has not lost its independence and should continue auditing the client ("explain").223 The model would also require that the PCAOB inspect companies which meet certain size criteria (essentially, the major companies) and force rotation if auditor independence is found to be lacking.224 If the company's audit was determined successful by the PCAOB, then the company could continue with its current audit firm if it (1) completed a "reproposal" and (2) its proposal was ratified by the company's shareholders.225 Breeden also briefly addresses the merits of adopting the "comply and explain" model for auditor independence.226 For example, the model's rebuttable presumption that the auditor is no longer independent would provide incentive for the audit committee to closely manage the audit process, while not overly circumscribing the audit committee's power to control its company's auditing process.227

C. "Future Exemplary Performance Approach"

In his statement to the PCAOB, Professor Henry T.C. Hu suggested an alternative to MAFR he describes as the "future exemplary performance approach."228 The mechanics of the approach have

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222. See Statement from Richard C. Breeden, supra note 204, at 8.
223. Id.
224. See id.
225. See id. at 8-9.
226. See id. at 9.
227. See id.
striking similarity to the “comply or explain” model. The future exemplary performance approach rests on two presumptions: (1) mandatory rotation as proposed is likely “too blunt an instrument,” with its overly rigid, “mechanistic” term limits;229 and (2) a more nuanced approach, with emphasis on analyzing individual client-auditor relationships and information, would likely alleviate some of the concerns surrounding the MAFR “one-size-fits-all” model.230 Hu describes a system where the PCAOB would set a term length with audit firm rotation required upon the term’s expiration unless the current audit firm receives a waiver from the PCAOB allowing the firm to continue with its engagement.231 The PCAOB would determine whether a waiver is granted by analyzing whether the current auditor, or another auditor, has “a greater likelihood of delivering truly exemplary performance” through the duration of the future term.232 To make such a determination, the PCAOB would use indicia including: (1) the auditor’s past performance for the client in question (and potentially the firms other clients as well);233 (2) whether the PCAOB finds any instances of fraud;234 (3) the PCAOB’s evaluation of non-public information regarding the audit;235 and (4) the auditor’s evaluation of the benefits and costs of continuing its audit tenure versus employing a new auditor.236 Hu argues that in addition to providing a more tailored analysis of the particular auditor’s performance,237 it tempers the unrealistic assumption that “the grass is always greener on the other side of the fence, [and] that somehow the new accounting firm will get everything right.”238 Further, it incentivizes the current auditor to provide superior performance compared to its competitors, especially if the auditor is subject to removal based on the PCAOB’s holistic evaluation of all of the firm’s clients, regardless of the comparative sizes of the companies.239 Hu asserts that this model would also foster

229. Id. at 114-15.
230. Id.
231. Id. at 115-16.
232. Id. at 116.
233. Id. at 116-17.
234. Hu, supra note 228, at 117.
235. Id.
236. Id. at 118.
237. See id. at 119-20.
238. Id.
239. See id. at 120.
active involvement of the audit committee in monitoring its auditor’s performance.\textsuperscript{240} The audit committee, in addition to desiring a quality audit, wants to maintain reasonable costs for the audit.\textsuperscript{241} Consequently, the audit committee would prefer ensuring the “exemplary performance” of the current auditor because rotation would likely be more expensive.\textsuperscript{242}

The “insurance model,” as the title implies, would require the public company to obtain insurance against losses due to material misstatements in their financial statements.\textsuperscript{243} After the company pays premiums to the insurance company, the insurance company would then select and pay for the audit.\textsuperscript{244} This “financial statement insurance” (FSI) is beneficial because the public company is no longer directly paying its auditor—the middle man insurer has taken over this role.\textsuperscript{245} Arguably, the layer of separation created by having the insurance company choose and pay the auditor allows the auditor to engage in a more independent, objective, and skeptical audit of the public company by requiring management’s valuations to be more reliable.\textsuperscript{246}

\textbf{D. Refocus on the Audit Committee}

The audit committee, in choosing and compensating the audit firm, insulates company management from the audit firm.\textsuperscript{247} To bolster this role of the audit committee, the PCAOB could, among other things, require the audit committee to receive proposals for replacing the current auditor and to interview these potential replacements without initial management involvement.\textsuperscript{248} Additionally, the audit committee

\begin{footnotesize}
\begin{enumerate}
\item Hu, supra note 228, at 120.
\item See id.
\item Id.
\item Id.
\item See id. Note that the benefit of this approach is that it may deal with some of the conflict of interest concerns expressed by the PCAOB Release No. 2011-006, infra note 97, at 15.
\item Ronen, supra note 243, at 56.
\item Id. at 5.
\end{enumerate}
\end{footnotesize}
could be given greater power to negotiate the audit fee in addition to its current duty to be the entity that actually pays the audit firm. Given the audit partner rotation that is currently required, the audit committee could examine the qualifications of potential audit partners prior to management’s involvement, to strengthen the supervising role of the audit committee over the audit partner. A requirement that the audit committee provide greater information regarding its oversight of the audit firm to investors might also promote transparency and allow investors to meaningfully compare the practices between companies regarding audit oversight.

E. Phase-in Approach

Charles A. Bowsher, the former Comptroller General of the United States, advocates for MAFR for the “Big Four” audit firms performing audits for large companies. Bowsher argues that the initial rules should include “between 25 and 40 large companies,” including “major financial institutions,” firms that the FDIC indicates are “Too Big to Fail,” major companies in fields like automotive manufacturing, etc., and large companies which “appear to have significant audit and/or accounting problems.” Bowsher asserts that if MAFR is initially restricted to the companies meeting these criteria, the increased costs associated with MAFR implementation will no longer be an issue, since the increased cost would still be minimal compared to the size of the companies and their “overall cost structure.”

249. _Id._ at 6.
250. _Id._
251. _Id._
253. _Id._ at 3-4.
254. _Id._ at 4.
Mandatory Audit Firm Rotation

F. Dual Audit

Former U.S. Comptroller Bowsher advocates for coupling the phase-in approach to MAFR with a “dual audit” performed by the current auditor and the incoming auditor during the term when auditors are rotated. This dual audit would culminate by having both firms prepare reports for the PCAOB, the Board of Directors, the SEC, and the public which analyze the financial standing of the company. Bowsher believes that the phase-in system paired with the “dual audit” would alleviate the “learning curve” concerns posed by opponents of MAFR.

G. Mandatory Retendering/Mandatory Request for Proposal (RFP)

In her statement to the PCAOB, Karen Nelson suggests mandatory audit tendering as “a compromise position” to MAFR. Richard Pozen, though using different terminology, similarly describes mandatory retendering as a “middle ground” in the debate for and against MAFR. Pozen focuses on the importance of the audit committee and the need for the company’s auditor to place its “loyalty” with the committee, and to resist pressure from company management. He argues that the PCAOB should mandate that companies accept bid proposals for the auditor position during a set period between ten and twenty years. Once the audit committee receives these bid proposals, including the proposal of the current

255. Id.
256. Id.
257. Id.
260. Id.
261. Id. at 1-2.
auditor, if provided, the committee would conduct a cost benefit analysis comparing audit quality to costs for transition to a new firm.\textsuperscript{262} Pozen asserts that costs incurred through the mandatory bidding process by the company would likely be offset by more competitive pricing from the candidate firms.\textsuperscript{263} Additionally, he argues that the prospect of replacement will incentivize the current auditor to perform a high quality audit for the client because: (1) the auditor does not want to be replaced, and (2) the auditor knows that another audit firm will critically analyze their work if they are replaced.\textsuperscript{264} The audit committee would benefit from more conscientious performance by the current auditor, and if the audit committee chooses to replace the auditor, it will do so with the knowledge of the costs of such a change, and presumably, the status quo will not be altered if the costs would be unduly burdensome compared to the perceived benefits.\textsuperscript{265}

\textit{H. “Rigorous Evaluation Process”}\textsuperscript{266}

Kenneth Daly, writing on behalf of the National Association of Corporate Directors (NACD), argues in his statement to the PCAOB that rigorous oversight of a company’s auditor by the company’s audit committee is a more effective way of increasing auditor “independence, objectivity and skepticism” than MAFR.\textsuperscript{267} Though still in its development, the NACD, along with the CAQ and others, created evaluation guidelines to aid audit committees in reviewing audit firms.\textsuperscript{268} The NACD argues that this evaluation process, when combined with new standards recently issued by the PCAOB and efforts to promote audit committee “education and awareness,” will ensure that audit committees satisfy their duty of monitoring the company’s audit firm.\textsuperscript{269}

\begin{itemize}
\item \textsuperscript{262} Id. at 2.
\item \textsuperscript{263} Id.
\item \textsuperscript{264} Id.
\item \textsuperscript{265} Statement from Richard C. Pozen, \textit{supra} note 259, at 2.
\item \textsuperscript{266} Letter from Kenneth Daly, President & CEO, Nat’l Ass’n of Corp. Directors, to the Pub. Co. Accounting Oversight Bd. 3 (Oct. 15, 2012), \textit{available at} http://pcaobus.org/Rules/Rulemaking/Docket037/ps_Daly.pdf (asserting that audit committee’s should rigorously evaluate auditors instead of implementing MAFR).
\item \textsuperscript{267} Id. at 1.
\item \textsuperscript{268} Id. at 3.
\item \textsuperscript{269} Id. at 3-4.
\end{itemize}
VI. CONCLUSION

The arguments against MAFR illustrate the burdensome and costly nature of such reform. If the PCAOB’s goal is to truly improve audit quality and bolster auditor independence, it should consider, based on the mounting evidence against MAFR, if there are less costly and more efficient methods of achieving the same goals. Rushing to implement MAFR as a means of accounting oversight and reform, as this paper discusses, could have tremendous effects on public companies, auditors, and shareholders. These changes should not be undertaken when there is significant evidence against MAFR implementation and only limited evidence in favor of it.\textsuperscript{270} Without convincing evidence that MAFR would improve audit quality, further action by the PCAOB should be limited to investigating the effects of recent reforms and the wisdom of future implementation of additional regulations like MAFR.

SARAH A. CORE

\textsuperscript{270} See supra Part IV.