CURRENT ISSUES IN AUDITING
Vol. 11, No. 1
Spring 2017
pp. A22–A44

American Accounting Association
DOI: 10.2308/ciia-51563

Audit Firm Perspective on Audit Firm Rotation and Enhancing Independence: Evidence from PCAOB Comment Letters

L. Tyler Williams
Bentley University

W. Mark Wilder
The University of Mississippi

SUMMARY: This study examines practitioners' perspectives on audit firm rotation and alternative solutions to enhance independence in the audit industry as solicited by the PCAOB's "Concept Release on Audit Firm Rotation and Auditor Independence." Accordingly, we synthesize the opinions found in comment letters of 15 American public accounting firms—eight of which are annually inspected by the PCAOB and seven of which are inspected tri-annually. Altogether, we find the firms generally offer homogenous rationale for opposition to audit firm rotation. However, most importantly, we note that the overwhelming majority of the alternative solutions offered by the firms to enhance the independence relationship between auditor and client lies with fortifying the audit committee. To that end, while regulators have generally attempted to strengthen independence by introducing regulation at the *auditor level,* our review indicates that perhaps a shift in regulatory philosophy is warranted—one that suggests progressing regulation at the *client level*.

Keywords: PCAOB; standard setting; audit regulation; independence; audit firm rotation.

Data Availability: Publicly available.

INTRODUCTION

This study synthesizes practitioners' perspectives on solutions to enhance independence in the auditor-client relationship as solicited by the Public Company Accounting Oversight Board

The authors gratefully acknowledge the helpful comments and suggestions of two anonymous reviewers, as well as participants at the 2014 Southeast AAA Regional Meeting in St. Petersburg, Florida and participants at the 2014 AAA Annual Meeting in Atlanta, Georgia.

Editor's note: Accepted by J. Gregory Jenkins.

Submitted: October 2014
Accepted: June 2016
Published Online: September 2016

(PCAOB 2011; hereafter, the Board) in its "Concept Release on Audit Firm Rotation and Auditor Independence" (the Concept Release). Using publicly available data from the PCAOB's website (specifically PCAOB Docket No. 37), we collect and summarize all comment letter responses submitted by American accounting firms to address two specific research questions.[1] One, what arguments are made to support practitioner opposition to audit firm rotation and, two, what do the firms appear to offer as the most salient solutions to enhance independence in the auditor-client relationship?

In August of 2011, the PCAOB issued the Concept Release to generate public opinion on efficient and effective vehicles for improvement in the independence relationship between auditor and client (PCAOB 2011). Through the release, the PCAOB requested comment on strengthening the independence relationship between auditor and client via specific questions related to audit firm rotation, as well as viable alternatives to audit firm rotation. Specifically, the general issue section of the release (outlined in Table 1) contains questions regarding enhancement to auditor independence, objectivity, and professional skepticism (general issue Question 1), feasibility of auditor rotation (general issue Questions 2 through 6), alternative solutions to mandatory audit rotation (general issue Question 7), and improvement to the PCAOB's inspection process (general issue Question 8). In addressing our research questions, the present study initially discusses practitioner rationale opposing audit firm rotation and then focuses primarily on alternative suggestions to improve independence—resulting in examination of firm comment letter responses to general issue Questions 2, 3, 5, 7, and 8.[2]

Altogether, this study summarizes the perspectives from 15 PCAOB-registered accounting firms on the Board's Concept Release. Of those 15 firms, eight are annually inspected by the PCAOB and seven are inspected tri-annually by the agency. Through their comment letters, each of these firms share their viewpoints on audit firm rotation but, most importantly, the firms also engage in proactive dialogue concerning alternative solutions to engender positive change in the auditor-client independence relationship. Of those alternative solutions to audit firm rotation, we find that the overwhelming majority of the comments are geared toward further empowering the audit committee, while a few solutions involve various suggestions aimed at firm quality control and regulation.

The study's primary contribution offers that practitioners overwhelming advocate for modification to the audit committee to augment auditor independence. This should be of interest to all those engaged in the auditor-client independence debate—regulators, academicians, practitioners, management, and investors. While regulators have traditionally attempted to strengthen independence by introducing regulation surrounding the external auditor, our review of audit firms' perspectives indicates that perhaps a shift in regulatory philosophy is warranted—one

[1] A total of 21 public accounting firms submitted a comment letter to Docket No. 37; however, only 15 were listed as PCAOB registrants with at least one issuer client as of the issuance of the Concept Release. Accordingly, we obtained those 15 comment letters, which we consider the entire population of responding accounting firms subject to PCAOB regulation.

[2] Our original intent was to also include general issue Questions 1, 4, and 6 in our analysis. However, in assessing the practitioners' comment letters we noted that the firms generally did not respond to Questions 1, 4, and 6. On occasion, firms did respond to one of these questions. For example, concerning general issue Question 4, Deloitte (2011) commented regarding whether the PCAOB should conduct a pilot program for mandatory rotation. Their response was that the regulation established in other countries effectively served as a pilot program for the PCAOB.

TABLE 1

Concept Release on Auditor Independence and Audit Firm Rotation

General Issue Questions
1. Should the Board focus on enhancing auditor independence, objectivity, and professional skepticism? How significant are the problems in those areas relative to problems in other areas on which the Board might focus? Should the Board simply defer consideration of any proposals to enhance auditor independence, objectivity, and professional skepticism?
2. Would audit firm rotation enhance auditor independence, objectivity, and professional skepticism?
3. What are the advantages and disadvantages of mandatory audit firm rotation? If there are potential disadvantages or unintended consequences, then are there ways a rotation requirement could be structured to avoid or minimize them?
4. Because there appears to be little or no relevant empirical data directly on mandatory rotation available, should the Board conduct a pilot program so that mandatory rotation of registered public accounting firms could be further studied before the Board determines whether to consider developing a more permanent requirement? How could such a program be structured?
5. According to the 2003 GAO Report, large firms estimated that a rotation requirement would increase initial year audit costs by more than 20 percent. What effect would a rotation requirement have on audit costs? Are there other costs the Board should consider, such as the potential time and disruption impact on company financial reporting staff as a result of a change in auditors? Are there implementation steps that could be taken to mitigate costs? The Board is particularly interested in any relevant empirical data commenters can provide in this area.
6. A 2003 report by the Conference Board Commission on Public Trust and Private Enterprise recommended that audit committees consider rotation when, among other factors, “the audit firm has been employed by the company for a substantial period of time—e.g., over 10 years.” To what extent have audit committees considered implementing a policy of audit firm rotation? If audit committees have not considered implementing such a policy, then why not? What have been the experiences of any audit committees that have implemented a policy of rotation?
7. Are there alternatives to mandatory rotation that the Board should consider that would meaningfully enhance auditor independence, objectivity, and professional skepticism? For example, should broader alternatives be considered that relate to a company’s requirement to obtain an audit, such as joint audits or a requirement for the audit committee to solicit bids on the audit after a certain number of years with the same auditor? Could audit committee oversight of the engagement be otherwise enhanced in a way that meaningfully improves auditor independence?
8. Should the Board continue to seek to address its concerns about independence, objectivity, and professional skepticism through its current inspection program? Is there some enhanced or improved form of inspection that could better address the Board’s concerns? If mandatory rotation were in place, then could an enhanced inspection, perhaps focused particularly on professional skepticism, serve as a substitute in cases in which it would be unusually costly, disruptive, or otherwise impracticable to rotate auditors?

that includes addressing independence strength at the *client level* rather than primarily at the *auditor level*.

AUDIT FIRM ROTATION AND INDEPENDENCE

Over the last decade the Board has passed 18 audit standards and proposed numerous other rules, releases, and advices. Most of these rulings have created little buzz among auditors and issuers.[3] However, one area of interest that serves as a continual catalyst for controversy is that of auditor independence. That said, regulators have generally shown interest in correcting the perception of maligned independence in the auditor-client relationship at the *auditor level* rather than the *client level*. For example, regulation surrounding the length of tenure of an auditor (at the firm, partner, and manager level) receives regular attention and discussion of revision. Also, services provided by an auditor to an audit client are often a target for criticism in the independence relationship debate. Although rare, augmenting the client's responsibilities in the relationship emerges as an alternative as well.

Perhaps the biggest outgrowth from the independence debate is the suggestion that accounting firms are mandated to rotate from audit engagements of publicly traded companies at some defined time period. The general consensus among U.S. corporations and audit firms is that audit firm rotation will lead to increased regulatory costs as well as lower-quality audits (Aubin 2013). The major benefit typically discussed in reference to auditor rotation is fairly ubiquitous: immediate improvement in independence between client and auditor. The argument made by pundits of rotation asserts that long-term client service relationships taint the ability of an independent auditor to remain skeptical, especially in those cases where the engagement is large and material to a firm's revenue base (Whitehouse 2013). However, many of those focused on silencing the rotation argument cite literature and empirical evidence that recognize little support for an inverse relationship between audit quality and auditor tenure. In fact, a plethora of studies find that audit quality is strengthened over time and is impaired at its fullest in the initial years of an engagement (e.g., Carcello and Nagy 2004; Ghosh and Moon 2005; Blouin, Grein, and Rountree 2007). Essentially, the anti-rotation argument rests on audit engagement infancy contributing to lack of exposure to the issuer-specific corporate model and an overall deficient understanding of core business practices, as well as a higher likelihood of undetected fraudulent reporting. Further, opponents submit that cost-benefits are disproportionate—typically citing a 2003 GAO report that suggests engagement costs balloon by upward of 20 percent in the initial year of an audit (McTague 2013).

Concerning regulators, the Sarbanes-Oxley Act of 2002 (U. S. House of Representatives 2002 [SOX; or, the Act]) dismissed the idea of mandating audit firm rotation in favor of other measures designed to combat independence issues between auditor and client. Primarily, the Act mandated that audit committees, independent of corporate management, take responsibility for all governance and continuance practice related to the external audit—including appointment of an auditor, approval of non-audit services, and determination of auditor compensation (Gupta, Weirich, and Turner 2013). SOX also hastened audit engagement partner rotation from seven years to five, while extending the mandatory partner cooling-off period to five years from the previous requirement of two. Most importantly, the Act established the PCAOB as the independent public company audit regulator.

[3] The potential effect of the PCAOB's standard-making process is substantial. Cullinan, Earley, and Roush (2013) note that approximately 15,000 to 17,000 issuer audits are performed annually.

Amid renewed interest in the auditor-client independence relationship spurred by the global financial crisis, the PCAOB (2011) again approached the subject of the auditor-client independence relationship when the agency issued its 2011 Concept Release. At the same time, peer regulatory authorities in other jurisdictions such as the European Union (EU) began to consider the idea of instituting audit firm rotation. In fact, the EU (2014) formally adopted mandatory audit firm rotation into law on May 27, 2014. Among other items, the legislation mandates a change in auditors after ten years of service for publicly traded entities (effective in June 2016). However, the tenure can be extended for upward of 24 years for those engaged in joint audits and upward of 20 years for those companies that engage in retendering the audit.[4] Additionally, the regulation prohibits any contractual obligation in banking agreements that require a Big 4 audit—effective June of 2017 (EU 2014).

The PCAOB has suggested it will monitor audit firm rotation programs; however, the controversy/limitations of audit firm rotation in the United States may preclude the PCAOB from instituting such regulation. However, audit rotation programs may be established organically by public companies. For example, Apple Inc. has purposefully retendered its auditor every five years for decades (McTague 2013). Most recently, two prestigious organizations, the London Stock Exchange and Unilever, dropped long-time auditor PricewaterhouseCoopers (PwC) in a stated attempt to overhaul their audit relationships in a time of changing market expectations (Kleinman 2013).

While firm opinion on audit firm rotation is of interest, the crux of the current study lies with disseminating practitioners' perspectives regarding viable alternatives to enhance the auditor-client independence relationship. Previewing our results, we find that the American accounting firms believe that retooling and strengthening the client's audit committee is the overwhelming resolution to enhance independence. Beyond developing the base expectations of the auditor-audit committee relationship through SOX, regulators have since established little guidance for the audit committee. Further, at least superficially, it appears monitoring and updating the standards of Title III of the Act (related to corporate responsibility) have taken a backseat to improving the tenors of Title II (related to auditor responsibility). Taken at face value, the practitioner perspective on ameliorating independence concerns at the *client level* as opposed to the *auditor level* might seem disingenuous and self-serving. However, looking at the suggestions from a different angle, the firms appear to implore regulators to consider strengthening the entity charged with both monitoring their work and keeping management at bay. This introduces a shift in the current paradigm, whereby the client would be charged with accepting more responsibility and accountability in the independence relationship.

[4] Joint audits are noted as a situation where a financial statement audit is completed by two or more audit firms—while still concluding with a single audit report. Retendering is the act of putting services related to a financial statement audit out for open bid. Both are seen by regulators as a vehicle to promote competition among public accounting firms. Joint audits and retendered audits have shortcomings. For example, as pointed out by Deng, Lu, Simunic, and Ye (2014), independence and audit quality are likely impaired in joint audit scenarios for one of two reasons: (1) the structure induces a free-riding problem, which lowers evidence precision, and (2) the environment compromises independence by creating an opportunity for internal opinion shopping. Specific to the pitfalls of retendered audits, more disclosure about the audit function may improve investor understanding of continuance practices. However, at the same time, audit quality would likely suffer from a reduction in domain-specific knowledge after the retendering grace period ends. Still, concerning the impact on independence and audit quality for both joint audits and retendered audits, little empirical evidence exists currently to assess the costs and benefits of each.

DATA COLLECTION

According to Königsgruber (2013), accounting professionals are viewed as one of the most active participant groups in lobbying their standard setters. Importantly, the PCAOB considers its public opinion forum an integral component in the development of the Board's public company audit guidance (PCAOB 2014b). To that end, as the PCAOB advances its regulation agenda, the agency actively solicits and receives public comment from a variety of constituent groups—many of which are professional accountants. Regarding the PCAOB's public forum, public accounting firms have a vested interest in the authoritative guidance promulgated by the agency because registered public accounting firms are the primary entities subject to the PCAOB's regulation.

The PCAOB uses an online document repository system to maintain individual files for each rulemaking document publicly released, as well as those constituent documents written in response to the rulemaking releases. The individual files are organized by "docket" number. The PCAOB maintains 40 dockets on its website, where Docket 37 contains all of the publicly available information related to the PCAOB's Concept Release explored in this study. We obtain the comment letters of all public accounting firms that submitted a response to the PCAOB's Concept Release, with relevant information outlined in Table 2.

We examine the comment letter perspectives of firms that meet two basic criteria as of the issuance of the Concept Release: (1) the firm is registered with the PCAOB, and (2) the firm retains at least one public company audit subject to PCAOB inspection.[5] This eliminated six firms from the study found in Table 2: BeachFleischman PC; Cravath, Swaine & Moore LLP; Gorman & Associates P. C.; Packer Thomas; PKF International Limited; and Praxity AISBL. Of those accounting firms meeting the aforementioned criteria, the study includes the four largest global accounting firms (commonly referred to as the "Big 4") Deloitte LLP, Ernst & Young LLP, KPMG LLP, and PwC LLP, as well as the next four largest global firms—BDO USA LLP, Crowe Horwath LLP, Grant Thornton LLP, and McGladrey & Pullen LLP. As depicted in Table 2, these eight firms are inspected annually by the PCAOB. The study also utilizes the comments of seven American regional firms—Battelle & Battelle LLP, BKD LLP, Eide Bailly LLP, EisnerAmper LLP, Piercy Bowler Taylor & Kern, UHY LLP, and WeiserMazars LLP. These seven firms are inspected by the PCAOB on a tri-annual basis.[6]

PRACTITIONER PERSPECTIVES ON AUDIT FIRM ROTATION

We parse firms' perspectives on audit firm rotation into several subcategories of firm type: Big 4 firm, non-Big 4 firm, regional firm, annually inspected firm, tri-annually inspected firm, and overall. As expected, none of the firms illustrate support for audit firm rotation, while 33 percent of overall firms show support for remedial rotation. Of note, we find that two of the Big 4 and three regional accounting firms support remedial rotation while all four non-Big 4 and two regional

[5] This is acknowledged by each firm through its annual filing of PCAOB Form 2, which requires that the firm self-report as an entity issuing an audit report for at least one issuer.

[6] Even though our final sample includes only 15 responding firms, together they audit more than 99 percent of the global market capitalization of U.S. issuers. A speech by PCAOB board member Jeanette Franzel in 2013 provided data that were included in an article published on goingconcern.com (Newquist 2013). These data indicated that "based on 2012 year-end data, the four largest registered public accounting firms (and their global affiliates) audited more than 98 percent of the global market capitalization of U.S. issuers. The next three largest firms (and their global affiliates) audited another 1.1 percent of this market capitalization" (Newquist 2013).

TABLE 2

Concept Release on Auditor Independence and Audit Firm Rotation Comment Letter Submission—Inspected Firms

Firm[a]	Registered with PCAOB[b]	PCAOB Description of Firm[c]	Inspection Classification[d]	Year of Last Inspection Report[e]	Failure to Address Quality Control Criticisms Satisfactorily[f]
Battelle & Battelle LLP	†	A	Tri-Annual	2012	No
BDO USA LLP	†	A	Annual	2015	No
BeachFleischman PC	†	E	—	—	—
BKD LLP	†	A	Tri-Annual	2013	No
Cravath, Swaine & Moore LLP	○	—	—	—	—
Crowe Horwath LLP	†	A	Annual	2015	No
Deloitte & Touche LLP	†	A	Annual	2015	Yes; 2008, 2009
Eide Bailly LLP	†	A	Tri-Annual	2015	No
EisnerAmper LLP	†	A	Tri-Annual	2014	No
Ernst & Young LLP	†	A	Annual	2015	Yes; 2010, 2011
Gorman & Associates P.C.	○	—	—	—	—
Grant Thornton LLP	†	A	Annual	2015	Yes; 2009, 2010
KPMG LLP	†	A	Annual	2015	Yes; 2011, 2012
McGladrey & Pullen LLP	†	A	Annual	2015	No
Packer Thomas	†	E	—	2009	No
Piercy Bowler Taylor & Kern	†	A	Tri-Annual	2015	No
PKF International Limited	X	—	—	—	—
Praxity AISBL	X	—	—	—	—
PricewaterhouseCoopers LLP	†	A	Annual	2015	Yes; 2009, 2010
UHY LLP	†	A	Tri-Annual	2014	No
WeiserMazars LLP	†	A	Tri-Annual	2014	No

[a] We use the PCAOB's Rulemaking Releases and Comments webpage (specifically Docket No. 37) to identify all public accounting firms submitting and declaring a firm-wide stance through a comment letter response to the PCAOB's (2011) *Concept Release on Auditor Independence and Audit Firm Rotation*. For further reference, see http://pcaobus.org/Rules/Rulemaking/Pages/Docket037Comments.aspx.

[b] A publicly accessible listing of all registered firms is maintained on the PCAOB's website. For further reference, see http://pcaobus.org/Registration/Firms/Pages/RegisteredFirms.aspx.

[c] According to the PCAOB registration bylaws, "each registered firm is required to file an annual report that indicates which of these categories (*A—Audit report for at least one issuer; B—No audit reports for issuers, but played a substantial role in the audit of at least one issuer; C—Audit reports for at least one broker-dealer; D—No audit reports for broker-dealers, but substantial role in audit of at least one broker-dealer; E—None of the above; F—No Form 2 filed*) applies to the firm's audit practice for the 12-month period covered by the annual report." For further reference, see http://pcaobus.org/Registration/Firms/Pages/RegisteredFirms.aspx.

[d] Each PCAOB registered firm is inspected either annually or tri-annually. For further reference, see http://pcaobus.org/Inspections/Pages/default.aspx.

[e] Individual inspection reports are made publicly available by the PCAOB. For further reference, see http://pcaobus.org/Inspections/Reports/Pages/default.aspx.

[f] The PCAOB lists firms that failed to satisfactorily address quality control criticisms on its website. Only the United States registrant of the partnership is considered in this study. For further reference, see http://pcaobus.org/Inspections/Reports/Pages/FirmsFailedToAddressQCSatisfactorily.aspx.

(continued on next page)

TABLE 2 (continued)

X Indicates the firm is part of a global alliance of independent firms. As such, each firm of the alliance is subject to independent registration and inspection.
○ Indicates the firm is not registered with the PCAOB and is not currently part of the PCAOB inspection program.
† Indicates the firm is registered with the PCAOB and is currently part of the PCAOB inspection program.

accounting firms do not show support for remedial rotation (four firms overall chose not to address this topic).[7] Through further examination of the comment letters, we find several common themes among the 15 firms for both their rationale against audit firm rotation, as well as their insight into potential adverse effects caused by audit firm rotation. We explore the more salient commonalities found in the comment letters in an effort to gauge agreement among the audit firms. Table 3 summarizes these findings.

First, we note that 100 percent of the firms suggest that no evidence exists to indicate that prolonged audit firm tenure is related to diminished audit quality, where many of the firms cite academic literature to support their argument. Further, before considering additional authoritative guidance on audit firm rotation, KPMG (2011) suggests that the PCAOB's engagement quality review and risk assessment standards, as well as its staff practice alerts, have been heavily lauded by the Board and should be given sufficient time to assess their effect on independence. Accordingly, we note that 88 percent of the annually inspected firms (one of eight chose not to address this topic) and 71 percent of the tri-annually inspected firms (five of seven, where two chose not to address) offer that the PCAOB should allow time for the current standards to materialize.

Of particular interest, firms such as BKD (2011) and McGladrey & Pullen (2011) contend that specialized industry expertise within certain geographic regions as well as specific industries does not exist interchangeably among the firms. In fact, an analysis performed on audit specialization notes that of the 500 largest public companies only two or three audit firms have a significant client base in certain industries (Deloitte 2011). Combing the letters, we note that 80 percent of all firms (100 percent of the annually inspected firms and 57 percent of the tri-annually inspected firms) believe that the requisite specialized knowledge needed to perform audits interchangeably across industries does not exist. Broken down further, eight of the 11 non-Big 4 firms (the other three chose not to address this topic) agree that audit specialization does not exist at a level sufficient to support audit firm rotation. Considering non-Big 4 firms conceivably have the most to gain regarding an increase in their client bases, advocating against audit firm rotation by admitting that certain expertise does not exist beyond the Big 4 is particularly interesting.

Firms believe that the PCAOB's oversight of the profession has enhanced audit quality, where KPMG (2011) suggests that the inspection program incentivizes auditor independence by providing audit teams with the possibility that "fresh eyes" might review the work. Further, Ernst & Young (2011) submit that the inspection process has made a profound effect on the firm's audit practice—a summary of annual inspection findings is distributed to all audit teams in an effort to facilitate professional awareness and discussion of significant auditing concerns. We find that 93 percent of the firms indicate that the PCAOB's inspection process is one of the main contributors to increases in audit quality (one regional firm chose not to address this topic).

[7] In the context of this study, the phrase "chose not to address this topic" indicates that a firm did not state a preference for (and did not address) the subject matter in its respective comment letter to the PCAOB.

TABLE 3

Concept Release on Auditor Independence and Audit Firm Rotation
Firm Perspective on Audit Firm Rotation

Panel A: Rationale for Stance against Audit Firm Rotation

Firm	Support for Remedial Rotation	Prolonged Audit Tenure Unrelated to Diminished Audit Quality	Other Audit Standards Have Not Been Given Proper Time to Materialize	Requisite Specialization Needed	PCAOB Inspection Process Improves Audit Quality
Deloitte[a]	†	†	†	†	†
Ernst & Young[a]	†	†	†	†	†
KPMG[a]	○	†	†	†	†
PricewaterhouseCoopers[a]	○	†	†	†	†
Subtotal Big 4 Support	50%	100%	100%	100%	100%
BDO[a]	X	†	†	†	†
Crowe Horwath[a]	X	†	○	†	†
Grant Thornton[a]	X	†	†	†	†
McGladrey & Pullen[a]	X	†	†	†	†
Subtotal Non-Big 4 Support	0%	100%	75%	100%	100%
Battelle & Battelle[t]	†	†	†	○	†
BKD[t]	X	†	†	○	†
Eide Bailly[t]	†	†	○	†	†
EisnerAmper[t]	○	†	○	†	†
Piercy Bowler Taylor & Kern[t]	X	†	†	†	†
UHY[t]	†	†	†	○	○
WeiserMazars[t]	○	†	†	†	†
Subtotal Regional Firms Support	43%	100%	71%	57%	86%
Subtotal Annually Inspected Firms Support	25%	100%	88%	100%	100%
Subtotal Tri-Annually Inspected Firms Support	43%	100%	71%	57%	86%
Total Firm Support	33%	100%	80%	80%	93%

(continued on next page)

TABLE 3 (continued)

Panel B: Effects of Audit Firm Rotation

Firm	Increased Audit Cost Effect	Diminished Audit Quality Effect	Diminished Financial Reporting Quality Effect	Adverse Firm Workforce Effect	Diminished Audit Committee Effect
Deloitte[a]	†	†	†	†	†
Ernst & Young[a]	†	†	†	†	†
KPMG[a]	†	†	†	†	†
PricewaterhouseCoopers[a]	†	†	†	†	†
Subtotal Big 4 Support	100%	100%	100%	100%	100%
BDO[a]	†	†	○	†	†
Crowe Horwath[a]	†	†	○	○	†
Grant Thornton[a]	†	†	†	†	†
McGladrey & Pullen[a]	†	†	○	○	○
Subtotal Non-Big 4 Support	100%	100%	25%	50%	75%
Battelle & Battelle[t]	†	†	○	○	○
BKD[t]	†	†	○	†	○
Eide Bailly[t]	†	†	○	○	†
EisnerAmper[t]	†	†	○	†	○
Piercy Bowler Taylor & Kern[t]	†	†	○	†	†
UHY[t]	†	○	○	†	○
WeiserMazars[t]	†	†	○	†	†
Subtotal Regional Firms Support	100%	86%	0%	71%	43%
Subtotal Annually Inspected Firms Support	100%	100%	63%	75%	88%
Subtotal Tri-Annually Inspected Firms Support	100%	86%	0%	71%	43%
Total Firm Support	100%	93%	33%	73%	67%

[a] Indicates the firm is annually inspected by the PCAOB.
[t] Indicates the firm is tri-annually inspected by the PCAOB.
○ Indicates the firm did not address this topic.
X Indicates the firm disaffirmed support in comment letter.
† Indicates the firm affirmed support in comment letter.

As noted in Table 3, 100 percent of the firms suggest that increased costs stemming from rotation would outweigh the benefits of rotation. Stated best, firms generally indicate that audit firm rotation has been examined several times in the U.S. and does not pass the cost-benefit test, where the primary concern is not direct engagement costs but the costs of diminished audit quality and impaired reliability of financial reporting (PwC 2011). Further, beyond jeopardizing audit quality, Crowe Horwath (2011) argues that audit firm rotation would introduce significant new engagement risks, as well as create unintended consequences deleterious to the audit function. In fact, 93 percent of firms (100 percent of the annually inspected firms and 86 percent of the tri-annually inspected firms) agree that diminished audit quality would occur as a result of rotation (the remaining firm chose not to address this topic), while all Big 4 firms advocate that diminished financial reporting quality would also likely occur (where 10 of 11 non-Big 4 firms chose not to address this topic).

According to Ernst & Young (2011), employing audit firm rotation would also be cumbersome from a staff retention perspective, where rotation among entire teams of auditors might cause professionals to seek other careers to avoid excessive travel or relocation. Continuous turnover of clients could also inflate firms' direct costs through incessant recruiting expenses, relocation of personnel, and severance payments (BDO 2011). Comment letters point out that 73 percent of firms contend that a disruption in the workforce would occur due to continuous attrition of the firm's client portfolio.

Perhaps the most condemning argument against audit firm rotation suggested by the firms is that the practice would undermine the spirit of SOX and lead to deterioration of corporate governance (Crowe Horwath 2011). As pointed out by Grant Thornton (2011), SOX empowered the audit committee to appoint the auditor, approve all services, and oversee the entire audit function. Audit firm rotation would dismiss the relevance of the committee's role and could cause unintended consequences such as inadequate monitoring of the audit firm, as well as diminished interaction with independent directors. We note that nine of 15 firms (67 percent) cite that rotation would cause audit committees to lose their effectiveness (all other firms chose not to address this topic); simultaneously, we also find that the overwhelming majority of firm alternative solutions to rotation lie with improving the auditor-client relationship at the *client level*. As noted in the following section, the firm comment letters examined in this study advocate for wholesale upgrades to the audit committee in an effort to enhance the monitoring component of the independence relationship. Strengthening the audit committee as opposed to the external auditor creates a paradigm shift in thought regarding regulatory philosophy.

ALTERNATIVE SOLUTIONS TO ENHANCE INDEPENDENCE

On February 5, 2014, during a budgetary meeting between the SEC and the PCAOB, Chairman James Doty intimated that the PCAOB would no longer pursue audit firm rotation—effectively refocusing the independence agenda going forward for the PCAOB (Chasan 2014). At least in the short term, this indicates that the PCAOB will shift its efforts in improving independence and professional skepticism. In fact, the PCAOB currently lists "Auditor Independence, Objectivity, and Professional Skepticism" on its June 30, 2014 Office of the Chief Auditor (OCA) Standard-Setting Agenda (PCAOB 2014a). Here, the topic is listed under "Other Active Projects" with a status of "Next steps under consideration" (PCAOB 2014a). Of note, the December 31, 2013 version of the standard-setting agenda listed the project as "Auditor Independence and Audit Firm Rotation."

After considering the firms' perspectives on audit firm rotation, we examine the individual firm comment letters submitted in response to the PCAOB's Concept Release for alternative suggestions to enhance independence. As previously noted, 67 percent of the firms (88 percent of annually inspected firms and 43 percent of tri-annually inspected firms) indicated that audit firm rotation would cause a diminished effect on the audit committee. In fact, firms suggest that audit firm rotation would undermine the committee's responsibility—an original tenet of the Act. According to the firms, a significant focus of the independence discussion should be centered on improvement to audit committee effectiveness.[8]

The extant academic research supports this sentiment. Following Francis (2004), multiple studies present evidence that audit quality is directly impacted by the independence attribute of an audit committee. Here, the author relays that audit committees demonstrating robust independence are attributed with a higher likelihood of auditors issuing going concern opinions as well as maintaining a lower likelihood of firing an audit firm post-issuance of a going concern opinion. Further, among audit committees displaying strong independence traits, abnormal accruals (earnings management) are less persistent, while external auditors are noted to have a higher likelihood of detecting accounting irregularities.

Through their comment letters to the PCAOB, the firms propose that strengthening various artifacts of the audit committee would have an important effect on the auditor-client independence relationship, advocating that commitment to its strengthening should be a primary objective of the independence debate. This study summarizes firms' perspectives on improving the effectiveness of the audit committee while briefly echoing practitioners' opinions on other suggestions regarding improvement to the auditor-client relationship.

Audit Committee Effectiveness

For the audit function to operate efficiently and effectively, it must be overseen in the same manner. Accordingly, an integral component of the financial reporting process is the development of strongly independent and influential audit committees. Implementing new methods for strengthening the effectiveness of audit committees would benefit stakeholders in that it would provide a vehicle for enhancing independence and, as a result, audit quality would improve (BKD 2011). In turn, the effectiveness of the audit committee, a fundamental precept in the management of an issuer's audit quality, would have an important impact on an issuer's financial reporting (Deloitte 2011). In the following three sections, we note the practitioner perspective on improving the audit committee (see Table 4) through strengthening components surrounding its overall function, communication, and regulation.

Audit Committee Function

Related to the comments taken directly from audit firms, practitioners actually request that audit committees act independent of management and serve as effective counterbalances to management pressure straining the auditor-client independence relationship (Ernst & Young 2011). Strictly regarding the continuance process, practitioners submit to the PCAOB that the direct reporting relationship between firm and audit committee needs greater emphasis by suggesting that the audit committee play the *most prominent* client-side role in continuance. Firms

[8] Of note, the Center for Audit Quality (CAQ) also champions the strengthening of audit committee effectiveness. In 2012, the CAQ developed the Audit Committee Collaboration program to design support tools for audit committees. The projects undertaken by the CAQ's initiative thus far include devices for assessing the quality of the external auditor's work and for creating a more transparent audit committee report—two ideas expressed in the firm comment letters (CAQ 2012).

TABLE 4

Response to PCAOB Concept Release on Auditor Independence Audit Committee Function*

Committee Continuance Process

1. Act autonomously and independently of management.[(b)]
2. Serve as an effective counterbalance to any undue management pressures on the audit process while fostering an independent and skeptical auditor mindset.[(b)]
3. Emphasize the direct reporting relationship between the audit firm and the audit committee by ensuring that, when a change in auditors is under consideration, the audit committee plays a prominent role in the process.[(a), (i)]
4. Require that audit committees meet with candidate audit firms without prior review of the firms by management. Additionally, the audit committee could be designated as the recipient of proposal.[(a)]
5. Focus on independence by including a robust preapproval process for audits and permissible non-audit services.[(b)]
6. Provide guidance on audit fee negotiation.[(a)]

Committee Best Practices and Training

7. Weigh quality as the key factor in appointing, compensating, and overseeing the work of auditors.[(b)]
8. Gain additional audit expertise by requiring that at least one member of the audit committee be an “auditing expert” or by expanding the definition of “financial expert” to include experience overseeing an external audit.[(a), (e)]
9. Be sufficiently resourced, with requisite financial expertise and such funding as they determine necessary to execute responsibilities.[(b)]
10. Engage with private sector groups to highlight and share with audit committees the leading practices, including those that promote auditor skepticism and objectivity.[(b)]
11. Use efficient and balanced joint audits to increase audit quality and independence of the auditors.[(b)]
12. Initiate firm rotation as deemed necessary or appropriate.[(h)]

* As indicated by the superscripts following the individually numbered alternative solutions, the letters indicate how the authors attributed the alternative solution to a specific firm or group of firms. These solutions were obtained directly from the individual comment letters submitted by the firms to the PCAOB in response to the Concept Release: (a) Deloitte (2011); (b) Ernst & Young (2011); (c) KPMG (2011); (d) PricewaterhouseCoopers (2011); (e) BDO (2011); (f) Crowe Horwath (2011); (g) Grant Thornton (2011); (h) McGladrey & Pullen (2011); (i) Battelle & Battelle (2011); (j) BKD (2011); (k) Eide Bailly (2011); (l) EisnerAmper (2011); (m) Piercy Bowler Taylor & Kern (2011); (n) UHY (2011); and (o) WeiserMazars (2011).

recommend that audit committees meet with potential candidate firms without the pre-approval of management and add that the committees should provide guidance on fee negotiation (Deloitte 2011). Directly related to the Act, audit firms appeal to the PCAOB, as well as the SEC, to ensure that audit committees possess, in both fact and appearance, sole responsibility over the continuance process. In fact, although implicit, practitioner comment letters appear to advocate that the original SOX requirements surrounding continuance are nothing more than a straw man.

Concerning best practices and training, firms consider assessing the quality of work performed by external auditors as the key factor in oversight of the audit function (Ernst & Young 2011). These practitioners also promote the use of client-led audit firm rotation as well as construction of joint audit teams as deemed necessary by the audit committee (McGladrey & Pullen 2011; WeiserMazars 2011). To that end, firms advocate that audit committees require at least one member of the audit committee possess the requisite skills as an auditing expert or well-rounded financial expert (Deloitte 2011; Ernst & Young 2011; BDO 2011). Further, firms believe that public companies should develop audit committee roundtables for the dissemination of practices designed to best effectuate robust independence relationships.

Overall, as suggested by Eide Bailly (2011), academic research asserts that there is a linear relationship between audit quality and informed, diligent audit committees. Noted throughout the literature, audit quality is directly influenced by the auditor-client independence relationship. To the extent that audit committees take ownership of the audit function and continuance processes, independence will improve, and as a result audit quality will increase.

Audit Committee Communication

Also of paramount importance to the audit function, the basis for building trust in a relationship among audit engagement stakeholders is the level of communication and disclosure of value-relevant, salient information (WeiserMazars 2011). The firms note that increased communication between audit firms, audit committees, and shareholders is vital to improving the independence and transparency of the audit (McGladrey & Pullen 2011; Ernst & Young 2011). Therein, practitioners suggest audit committees provide firms with an annual agenda of deliverables as well as timely formal evaluations and job satisfaction feedback. Further, firms submit that audit committees should thoroughly review the audit plan and request that their respective auditors provide increased effort around particularly risky areas of the audit. Firms even invite audit committees to inquire about findings from PCAOB inspections, as well as firm quality control inspections, to facilitate a desired comfort level (Ernst & Young 2011). Overall, ensuring that thoughtful, timely discussion between the audit committee and the auditor is undertaken on a regular basis will engender a stronger independence relationship, which in turn will foster a more robust audit function (Deloitte 2011; KPMG 2011).

Addressing the majority of the communication comments at the auditor level, the PCAOB issued Auditing Standard No. 16 (AS No. 16, PCAOB 2012a), "Communications with Audit Committees; Related Amendments to PCAOB Standards; and Transitional Amendments to AU Section 380" in August 2012. Table 5 shows that six of the seven auditor-audit committee communication suggestions noted in this study were mandated by AS No. 16. Of note, the PCAOB did not elect to require the auditor to discuss firm PCAOB inspection results with audit committees. The regulator justifies this by stating that the Act limits the Board's authority to force public disclosure of nonpublic inspection information. However, the agency did state that the Act does not restrict audit firms from disclosing inspection findings (including firm remediation and deficiencies in quality control) on their own volition to audit committees (PCAOB 2012a).

Where communication is concerned, the PCAOB states, "An audit committee that is well-informed about accounting and disclosure matters relating to the audit may be better able to carry out its role of overseeing the financial reporting process" (PCAOB 2010). That said, as the PCAOB has adopted communication requirements for the external auditor through AS No. 16, to yield a more robust independence relationship, it is important for regulators to consider other mandatory communication involving the audit committee to investors as well as auditors.

Audit Committee Regulation

Firm comment letters offer suggestions for improving audit committee effectiveness through action from both key regulators present in the audit function—the PCAOB and the SEC (see Table 6). Concerning the PCAOB, practitioners believe that the agency should implement a judgment framework for evaluating the reasonableness of management's estimates in concert with

TABLE 5

Response to PCAOB Concept Release on Auditor Independence Audit Committee Communication*

Auditor and Audit Committee Interaction

Audit Committee

1. Dialogue diligently with auditors regarding the quality of financial reporting. It is important that auditors and audit committees fully engage in meaningful two-way communication, especially as it relates to areas that are highly subjective in nature.[h]
2. Engage in a regular dialogue outside scheduled meetings with the audit team.[b]
3. Establish expectations with the auditor about the nature and method of communications and the exchange of insights with the auditor, and evaluate auditors against those expectations.[b], [k]
4. Provide formal evaluations and regular feedback to the auditor.[b]
5. Set an annual agenda with the auditor to deliver not only efficient and effective audits but also to go beyond the compliance aspects of the audit and engage in discussions regarding key business initiatives in an increasingly global environment.[b]
6. Seek the auditor's views on the effectiveness of the company's governance process.[b]
7. Ask auditors about PCAOB inspection findings and the findings of their firm's internal quality reviews.[b]
8. Review the proposed audit plan and scope of work; ask auditors to perform more work if they would like the scope to be increased at specific locations or in particular risk areas, especially in multilocation environments.[b]

Auditor	Adopted in Audit Standard No. 16
9. Establish direct contact between the audit committee and key members of the audit team—including subject matter experts, industry experts, other specialists, and the engagement quality review partner.[a]	Yes
10. Collaborate with audit committee to better communicate the auditor's objectivity and skepticism, the auditor's internal system of control, and the auditor's lead engagement partners.[c]	Yes
11. Discuss significant accounting and auditing judgments with the audit committee to avoid situations in which time pressures (earnings release) constrain the exercise of appropriate objectivity and skepticism.[a]	Yes
12. Engage the audit committee in audit partner successor matters to emphasize the reporting relationship between the audit committee and the outside auditor, to facilitate the audit committee's understanding of the partner's appropriateness for the engagement, and to establish the relationship between the audit committee and the partner.[a], [c]	Yes
13. Discuss inspection results with the audit committee to provide insights relevant to their oversight generally and in particular to their auditor reappointment decisions.[a]	No

(continued on next page)

TABLE 5 (continued)

14. Inform the audit committee of national office consultations to help the audit committee understand how and why certain conclusions were reached during the course of the audit and to lend support to the outside auditor in discussions with management.[(a)]	Yes
15. Provide the audit committee with the audit plan for review, discussion, and approval.[(c)]	Yes

* As indicated by the superscripts following the individually numbered alternative solutions, the letters indicate how the authors attributed the alternative solution to a specific firm or group of firms. These solutions were obtained directly from the individual comment letters submitted by the firms to the PCAOB in response to the Concept Release: (a) Deloitte (2011); (b) Ernst & Young (2011); (c) KPMG (2011); (d) PricewaterhouseCoopers (2011); (e) BDO (2011); (f) Crowe Horwath (2011); (g) Grant Thornton (2011); (h) McGladrey & Pullen (2011); (i) Battelle & Battelle (2011); (j) BKD (2011); (k) Eide Bailly (2011); (l) EisnerAmper (2011); (m) Piercy Bowler Taylor & Kern (2011); (n) UHY (2011); and (o) WeiserMazars (2011).

developing training materials for audit committee oversight of the audit function (Deloitte 2011; Ernst & Young 2011). Firms emphatically note that audit committees should have access to direct interaction with PCAOB staff. Suggestions include the lead PCAOB staffer meeting with the audit committee chair prior to inspection, the PCAOB directly communicating inspection findings to the audit committee, and engaging with audit committees on matters of audit policy regardless of inspection status (Battelle & Battelle 2011; Deloitte 2011; Ernst & Young 2011; KPMG 2011; PwC 2011). Integral to the discussion, Deloitte (2011) offers that academic studies on audit committee performance post-SOX suggest that the robustness of an audit committee is a primary contributor to audit quality—the PCAOB could directly effectuate change by implementing the aforementioned requests.

Firms also submit that the SEC should define an expanded scope for the audit committee report that includes disclosing the audit committee's role and relative performance, as well as discussing the committee's assessment of the incumbent auditor's audit quality coupled with considerations in selecting a successor auditor (BDO 2011; KPMG 2011; McGladrey & Pullen 2011). This would allow audit committees to better inform investors whether and to what extent their interests are adequately represented by the independent committee charged with oversight of the audit function.

Altogether, utilizing the wealth of accumulated knowledge spurred by SOX to create audit committee guidance, which yields high-level external audit performance, is perhaps the backbone of remediating perceived problems with the strained independence relationship between auditor and client. By equipping audit committees with the tools to properly govern the audit process, regulators, including the PCAOB and SEC, can directly strengthen the independence relationship felt between auditor and client.

Other Alternative Suggestions

Firm Quality Control

In order to enhance independence, auditors must develop a sense of urgency in self-improvement. As such, those charged with assurance must become more adept at instituting policies and procedures to improve the entire audit industry. To that end, audit firms should also endeavor to find ways to strengthen their internal quality control systems (BDO 2011). Concerning training, as suggested by BKD (2011), consideration should be given to mandating annual training

TABLE 6

**Response to PCAOB Concept Release on Auditor Independence
Audit Committee Regulation***

PCAOB Interaction

1. Develop a judgment framework for the audit committee's evaluation of the reasonableness of management's estimates.[(a)]
2. Consider direct audit committee and auditor interaction with the PCAOB staff on both significant inspection findings and audit policy matters and standard setting more broadly.[(b), (i)]
3. Establish standards to promote the consistency of communications with audit committees by the independent accounting firm of PCAOB inspection results, together with any remediation related thereto, pertaining to their public company.[(d)]
4. Increase disclosure requirements by companies to shareholders concerning a change in the independent accounting firm beyond the current requirement to report on disagreements between the audit firm and the company to include more information on the audit committee's decision to change.[(d)]
5. Consider making it standard practice for the lead inspector to meet with the audit committee chair when commencing a PCAOB inspection.[(a)]
6. Review the protocols relating to the disclosure of Board inspection results to facilitate discussions on this subject between audit firms and audit committees.[(a), (c)]
7. Engage with audit committees on matters of audit policy.[(b)]
8. Provide training materials to inform audit committees about enhancing their oversight in a way that meaningfully improves auditor objectivity.[(h)]

SEC Interaction

9. Define an expanded scope for the audit committee report to inform investors about the audit committee's role and performance and provide comparable information across companies. The committee's efforts relating to auditor independence, objectivity, and professional skepticism are among the topics on which discussion should be expanded.[(a), (b), (c), (e)]
10. Disclose in the proxy material provided to shareholders as to whether the company's audit committee considered selecting an independent accounting firm other than the incumbent.[(d)]
11. Enhance audit committee reports included in the company's annual proxy statements to include discussion of the committee's process to evaluate the independent auditor's performance, including the actions it has taken to assess and protect the auditor's application of professional skepticism.[(b), (e)]
12. Move the audit committee report from the proxy statement to the Form 10-K to enhance its timeliness and prominence.[(a)]

* As indicated by the superscripts following the individually numbered alternative solutions, the letters indicate how the authors attributed the alternative solution to a specific firm or group of firms. These solutions were obtained directly from the individual comment letters submitted by the firms to the PCAOB in response to the Concept Release: (a) Deloitte (2011); (b) Ernst & Young (2011); (c) KPMG (2011); (d) PricewaterhouseCoopers (2011); (e) BDO (2011); (f) Crowe Horwath (2011); (g) Grant Thornton (2011); (h) McGladrey & Pullen (2011); (i) Battelle & Battelle (2011); (j) BKD (2011); (k) Eide Bailly (2011); (l) EisnerAmper (2011); (m) Piercy Bowler Taylor & Kern (2011); (n) UHY (2011); and (o) WeiserMazars (2011).

on independence and professional skepticism in order to bolster their perceived relevance in effective assurance practice and to tie them to objectivity and auditor judgment.

Aside from training, another way of improving firm quality control, as suggested by Deloitte (2011), might lie with the creation of firm audit quality advisory councils. Comprised of independent external advisers, these councils would be a radical step in delivering an unbiased perspective on firm audit quality as well as assessing firm problems with independence, objectivity, and professional skepticism. Perhaps controversial, PwC (2011) suggests that accounting firms that serve as the financial statement auditor of more than 100 issuers publish an annual report detailing the firm's commitment to internal quality control. Here, the report would also reveal important inner workings of the firm such as the audit partner compensation model and firm governance structure. Stated best, adherence to firm quality control standards created through proactive interaction with the regulators will most likely relate directly to ameliorating uncertainties surrounding the auditor-client independence relationship (KPMG 2011).

Regulation

The firms further responded to the PCAOB's request by illustrating a critical belief in enhancement to independence via the regulatory agenda. Among the areas of needed improvement, the firms suggest that the most beneficial would be enhancements to the standards and framework process, as well as inspection practices and development of PCAOB-led training. For example, PwC (2011) encourages the PCAOB to move forward with proposals to adopt certain changes to the standard auditor report—where proposed standards currently aim to incorporate the disclosure of explicit statements regarding firm independence, firm tenure, areas of complex auditor judgment, partner identity, and other external audit firm participation. The Board believes these disclosures will help spur a deeper level of comfort surrounding the external auditor for investors.

Concerning improvement to the inspection process at the PCAOB, firms note that the regulator should focus on identifying the root cause of deficiencies at the firm level, rather than engagement-specific deficiencies, and address the length of time that inspection teams take to draft and issue inspection reports (Eide Bailly 2011). Further, in an effort to be proactive during financial statement audits, firms believe that the PCAOB should adopt a practice similar to the consultation services provided by the SEC (Deloitte 2011). To further elaborate on the SEC practice, if uncertainty surrounding the application of GAAP is experienced by auditors, then audit committees, or management, then the SEC suggests consultation with the Commission's accounting staff.[9] Firms imply that similar guidance from the PCAOB would be most salient for an auditor in a pre-opinion scenario and would improve the audit function. However, the SEC staff also encourages consultation with the Office of the Chief Accountant (OCA) on auditing concerns as well, especially those that involve complicated transactions and concerns with auditor independence (SEC 2001). Therefore, while the PCAOB might not currently offer pre-opinion consultation on auditing or independence concerns, it appears that public accounting firms have an appropriate outlet to discuss concerns. Nonetheless, the firms' suggestion might encourage the SEC to prod the PCAOB into implementing a policy of consulting with audit firms on a pre-opinion basis. In fact, a form of pre-opinion consultation could help eradicate regulator concerns over independence that are currently only noted by the PCAOB in a post-audit inspection.

Non-Audit Firm Perspectives on Audit Firm Rotation and Auditor Independence

The PCAOB has hosted several open forums on the subject of auditor independence and audit firm rotation. In these meetings, some support was voiced for audit firm rotation (e.g., members of the PCAOB's standing advisory group), but the arguments against instituting rotation were clear—

[9] Here, an inquiring entity provides the SEC with a written submission replete with factual details, proposed accounting treatment, financial reporting impact, and relevant disclosures (a response is generated within three days after receipt by the SEC). Of note, the release specifically mentions that guidance on the SEC's Regulation S-X, which sets forth the requirements for auditor independence, is provided by the OCA (SEC 2012).

requisite domain-specific knowledge cannot be effectively gained over a period of a few years and will result in a reduction of audit quality. David Hirschmann, president and CEO of the U.S. Chamber of Commerce, Center for Capital Markets Competitiveness, says, "we support strong audit committee communications and auditor independence, but it is a hallmark of the American corporate structure . . . that directors and shareholders must be allowed to govern the corporation and that one size fit all mandates do not work" (Hirschmann 2012). In fact, William A. Osborn, audit committee chairman of Caterpillar Inc., asserts that rotation would undermine the audit committee's ability to govern in the best interest of shareholders, and further notes that he is confident in his committee's obligation to oversee that the auditor is professionally skeptical, objective, and independent (Osborn, Dickinson, and Greene 2011). The Board notes that most constituents favor the PCAOB considering less drastic alternatives such as mandatory retendering, more-targeted PCAOB inspections, audit-only accounting firms, joint audits, enhancing auditor training, and strengthening audit committees (PCAOB 2012b). Similar to the firms' viewpoints discussed in this paper, a host of alternative perspectives from audit committee chairs, chief accounting officers, academics, and portfolio managers also emphasize that the strength of the audit committee is the crucial element to facilitate more robust auditor-client independence.

In her October 8, 2012 public meeting statement, Michelle Edkins, managing director of Black Rock, focuses mostly all of her comments on the shareholder's perspective of boosting the utility of the audit committee. Most interesting, she suggests that her organization expects directors to be committed to training on technical issues, networking with others on best practices, and developing an understanding of cognitive biases, framing, and group dynamics related to decision making (Edkins 2012). The chief accounting officer of Northrop Grumman Corporation, Stephen E. Frank, suggests that the PCAOB better serve issuers by providing more timely results and reviews of the company's auditor directly to the audit committee. Further, he also mentions that the committee would benefit from the Board proactively communicating emerging issues and concerns from their inspections directly to audit committees (Frank and Heintz 2011). Similarly, the audit committee of Morgan Stanley opines that, where appropriate, the PCAOB should meet with audit committees to advise on concerns that the agency has about particular audit-client relationships (Nicolaisen, Davies, Hance, and Sexton 2011).

CONCLUSION

The chief objective of this study is to circulate the audit firm perspective on enhancement to the auditor-client independence relationship, as well as note practitioners' opinions on the pitfalls of implementing audit firm rotation. We find that the firms generally offer homogenous rationale for opposition to audit firm rotation; however, most importantly, we note that the overwhelming majority of the solutions offered to enhance independence lies with significant upgrades to audit committee effectiveness. That said, while regulators have generally been compelled to enhance independence by introducing regulation at the *auditor level,* our review indicates that perhaps a shift in regulatory philosophy is warranted. Accordingly, our study provides a succinct reference for those interested in exploring enhancement to independence through *client-level* improvement (principally through the audit committee) as opposed to improvement at the *auditor level*.

Audit Deficiencies

Audit deficiencies noted by the PCAOB inspection process have largely been referenced by the Board as the impetus to develop new audit regulation concerning independence and professional skepticism.[10] Notably, inspection teams cite that deficiencies in audit work are often related to impairment in the independence of the auditor as well as failure to display appropriate professional skepticism.

It is important to note that while the PCAOB has continued to find problems in inspected audits at the largest accounting firms in the country, the firms acknowledge this and provide a wealth of ideas to correct those problems in their comment letters to the PCAOB's Docket No. 37. In fact, in their alternative solutions to audit firm rotation, the firms list a variety of vehicles that can be used to help combat the aforementioned specific deficiencies at all levels of the audit. While suggestions surrounding the audit committee are the primary focus, improvements concerning the auditor and regulator are also articulated.

After the PCAOB has conducted an audit inspection, the firm has 12 months to demonstrate to the PCAOB that it has remediated all documented criticisms of the firm's quality control system. Upon examination of the remediation, the PCAOB determines whether the firm adequately complied; if not, then the inspections division issues a quality control criticism letter to the public reprimanding the firm. Of note, only two annually inspected firms have received a quality control criticism letter from the PCAOB for failure to remediate identified audit deficiencies since the 2011 inspection period (PCAOB 2015).[11]

Limitations and Future Research

Proactive communication in the PCAOB's public forum from audit firms, corporations, academics, professional associations, peer regulators, and individuals can significantly influence regulators in the evolution of audit guidance. Specifically, this study was contrived to collect and summarize practitioners' opinions on enhancing independence in an effort to facilitate improvement of the audit function. As the primary perspectives considered were those from professional accounting firms, we note that this has limited the contribution of our study. However, we also believe that it is a chance for future researchers to disseminate the collective thoughts of all commenters on PCAOB Docket No. 37, as well as other PCAOB forums documenting events and meetings on independence.[12] Along the same lines, further research is needed to document whether and to what extent the PCAOB uses constituent preference to effectuate change in its authoritative guidance. This line of research would effectively qualify the usefulness of the PCAOB's public forum with respect to how it shapes the Board's regulatory agenda.

As for future research ideas prompted by the findings of this study, we would like to see future research aimed at testing both firm rationale against audit firm rotation, as well as the alleged effects of audit firm rotation. First, have the aforementioned standards had enough time to materialize? Further, to what extent does audit firm specialization exist to supply the market with external auditors of interchangeable knowledge, how could this problem be ameliorated, and

[10] It is important to note that the PCAOB selects audit engagements from a subset of factors that increase the likelihood that an audit contains deficiencies; as such, the findings are not a representative sample of public company audits.

[11] Ideally, we would like to determine whether the alternative solutions suggested by the firms to address independence concerns help solve the core problems identified by the inspection process. However, a limitation of the study is that it is very difficult to make this presumption generally, and especially since these alternative solutions are not required at this time.

[12] For reference, see http://pcaobus.org/Rules/Rulemaking/Pages/default.aspx/, as well as http://pcaobus.org/News/Events/Pages/default.aspx/.

would implementing a joint audit process aid in increasing the ability to provide high-quality specialized knowledge? Researchers should also endeavor to answer questions regarding the suggestion that the PCAOB inspection process has improved audit quality as well as financial reporting quality. Going forward, as public companies registered in the EU employ audit firm rotation, future research streams might also consider quantification of increased audit costs regarding audit firm rotation as well as the effects of audit firm rotation on audit quality, financial reporting quality, and audit committee quality. Perhaps most interesting, a behavioral study related to the aforementioned adverse workforce effect would be beneficial in assessing how practitioners would react personally to audit firm rotation.

Regarding the role audit committees, auditors, and regulators play in the auditor-client independence relationship, future research could be tailored to answer the firm perspective on audit committee effectiveness, firm quality control, and regulation. For example, exploratory studies addressing simple questions surrounding the concentration of experts on audit committees, public companies that institute their own form of audit firm rotation, and quantifying audit committee level of independence from management would be particularly enlightening for regulators. In addition, an experiment conducted on the perception of audit committee expertise and resourcefulness might shed light on how investors feel about independence and professional skepticism surrounding the governance of the financial statement audit. Further, would direct interaction with the PCAOB heighten the audit committee's feeling of responsibility regarding the audit function? Concerning firm-level suggestions, would ideas such as firm advisory councils and publicly available firm quality control reports effectuate a change in mindset for the firms regarding independence? It would also be interesting to examine whether pre-opinion consultation with the PCAOB results in a reduction of inspection and remediation findings and costs. Finally, future researchers should endeavor to actually speak with (and interview) audit firm representatives regarding their views on how to improve independence and professional skepticism. This would bring richness and detail to the discussion.

REFERENCES

Aubin, D. 2013. *House May Vote Soon on Controversial Auditor Issue*. Available at: http://www.reuters.com/article/idUSL2N0F91GZ20130703

Battelle & Battelle. 2011. *RE: Concept Release on Auditor Independence and Audit Firm Rotation*. PCAOB Rulemaking Docket Matter No. 37 Release No. 2011-06. Dayton, OH: Battelle & Battelle LLP.

BDO. 2011. *RE: Concept Release on Auditor Independence and Audit Firm Rotation*. PCAOB Release No. 2011-006, Rulemaking Docket Matter No. 037. New York, NY: BDO USA LLP.

BKD. 2011. *RE: Concept Release on Auditor Independence and Audit Firm Rotation*. PCAOB Release No. 2011-006, Rulemaking Docket Matter No. 037. Springfield, MO: BKD, LLP.

Blouin, J., B. M. Grein, and B. Rountree. 2007. An analysis of forced auditor change: The case of former Arthur Andersen clients. *The Accounting Review* 82 (3): 621–650.

Carcello, J. V., and A. L. Nagy. 2004. Audit firm tenure and fraudulent financial reporting. *Auditing: A Journal of Practice & Theory* 23 (2): 55–69.

Center for Audit Quality (CAQ). 2012. *Enhancing the Audit Committee Report: A Call to Action*. Washington, DC: CAQ.

Chasan, E. 2014. *PCAOB's Auditor Rotation Project Is Essentially Dead*. Available at: http://blogs.wsj.com/cfo/2014/02/05/pcaobs-auditor-rotation-project-is-essentially-dead/?mod=WSJ_hps_sections_cfo

Crowe Horwath. 2011. *RE: Concept Release on Auditor Independence and Audit Firm Rotation*. PCAOB Rulemaking Docket Matter No. 37. Oak Brook, IL: Crowe Horwath LLP.

Cullinan, C. P., C. E. Earley, and P. B. Roush. 2013. Multiple auditing standards and standard setting: Implications for practice and education. *Current Issues in Auditing* 7 (1): C1–C10.

Deloitte. 2011. *RE: Concept Release on Auditor Independence and Audit Firm Rotation. Request for Public Comment on PCAOB Release No. 2011-006*. PCAOB Rulemaking Docket Matter No. 37. New York, NY: Deloitte Touche Tohmatsu Limited.

Deng, M., T. Lu, D.A. Simunic, and M. Ye. 2014. Do joint audits improve or impair audit quality? *Journal of Accounting Research* 52 (5): 1029–1060.

Edkins, M. 2012. *PCAOB Meeting on Auditor Independence, Objectivity and Professional Skepticism*. Public Meeting Statement. Available at: http://pcaobus.org/rules/rulemaking/docket037/ps_edkins.pdf

Eide Bailly. 2011. *RE: Concept Release on Auditor Independence and Audit Firm Rotation*. Request for Public Comment. Fargo, ND: Eide Bailly LLP.

EisnerAmper. 2011. *RE: Concept Release on Auditor Independence and Audit Firm Rotation*. Request for Public Comment on PCAOB Rulemaking Docket Matter No. 37. Edison, NJ: EisnerAmper LLP.

Ernst & Young. 2011. *RE: Concept Release on Auditor Independence and Audit Firm Rotation*. PCAOB Rulemaking Docket Matter No. 37. New York, NY: Ernst & Young LLP.

European Union (EU). 2014. L 158: Regulation (EU) no 537/2014 of the European parliament and of the council of 16 April 2014 on specific requirements regarding statutory audit of public-interest entities and repealing commission decision 2005/909/EC (1). *Official Journal of the European Union* 57: 77–112.

Francis, J. R. 2004. What do we know about audit quality? *The British Accounting Review* 36 (4): 345–368.

Frank, S. E., and K. N. Heintz. 2011. *RE: Concept Release on Auditor Independence and Audit Firm Rotation*. Release No. 2011-006L. Available at: http://pcaobus.org/Rules/Rulemaking/Docket037/293_Northrop.pdf

Ghosh, A., and D. Moon. 2005. Auditor tenure and perceptions of audit quality. *The Accounting Review* 80 (2): 585–612.

Grant Thornton. 2011. *RE: Concept Release on Auditor Independence and Audit Firm Rotation*. PCAOB Rulemaking Docket Matter No. 37. Chicago, IL: Grant Thornton LLP.

Gupta, P. P., T. R. Weirich, and L. E. Turner. 2013. Sarbanes-Oxley and public reporting on internal control: Hasty reaction or delayed action? *Accounting Horizons* 27 (2): 371–408.

Hirschmann, D. 2012. *Auditor Independence and Audit Firm Rotation*. Statement of the U.S. Chamber of Commerce. Available at: http://pcaobus.org/Rules/Rulemaking/Docket037/ps_David_Hirschmann.pdf

Kleinman, M. 2013. *LSE Calls Audit Review amid Industry Shake-Up*. Available at: http://news.sky.com/story/1120815/lse-calls-audit-review-amid-industry-shake-up

Königsgruber, R. 2013. Expertise-based lobbying and accounting regulation. *Journal of Management and Governance* 17 (4): 1009–1025.

KPMG. 2011. *RE: Concept Release on Auditor Independence and Audit Firm Rotation*. PCAOB Rulemaking Docket Matter No. 37. New York, NY: KPMG LLP.

McGladrey & Pullen. 2011. *RE: Concept Release on Auditor Independence and Audit Firm Rotation*. PCAOB Rulemaking Docket Matter No. 37. Bloomington, MN: McGladrey LLP.

McTague, J. 2013. *Auditing's World of Hurt*. Available at: http://www.barrons.com/articles/SB50001424052748703578204578523330503069720

Newquist, C. 2013. *The Big 4's Stranglehold on the Audit Market Is Worse than You Thought*. Available at: http://goingconcern.com/post/big-4s-stranglehold-audit-market-worse-you-thought

Nicolaisen, D. T., H. J. Davies, J. H. Hance, and G. Sexton. 2011. *RE: Concept Release on Auditor Independence and Audit Firm Rotation*. PCAOB Rulemaking Docket Matter No 37. Available at: http://pcaobus.org/Rules/Rulemaking/Docket037/329_Morgan_Stanley.pdf

Osborn, W. A., D. M. Dickinson, and J. J. Greene. 2011. *RE: Concept Release on Auditor Independence and Audit Firm Rotation*. PCAOB Rulemaking Docket Matter No 37. Release No. 2011-006. Available at: http://pcaobus.org/Rules/Rulemaking/Docket037/086_Caterpillar.pdf

Piercy Bowler Taylor & Kern. 2011. *RE: Concept Release on Auditor Independence and Audit Firm Rotation*. PCAOB Rulemaking Docket Matter No. 37. Release No. 2011-006. Las Vegas, NV: Piercy Bowler Taylor & Kern.

PricewaterhouseCoopers (PwC). 2011. *RE: Concept Release on Auditor Independence and Audit Firm Rotation*. PCAOB Rulemaking Docket Matter No. 37. New York, NY: PricewaterhouseCoopers LLP.

Public Company Accounting Oversight Board (PCAOB). 2010. *Proposed Auditing Standard Related to Communications with Audit Committees*. Washington, DC: PCAOB.

Public Company Accounting Oversight Board (PCAOB). 2011. *Concept Release on Auditor Independence and Audit Firm Rotation*. Notice of Roundtable. Washington, DC: PCAOB.

Public Company Accounting Oversight Board (PCAOB). 2012a. *Communications with Audit Committees; Related Amendments to PCAOB Standards; and Transitional Amendments to AU SEC*. Auditing Standard No. 16: Section 380. Washington, DC: PCAOB.

Public Company Accounting Oversight Board (PCAOB). 2012b. *Transcript: Public Meeting on Auditor Independence and Audit Firm Rotation*. Available at: https://pcaobus.org/Rulemaking/Docket037/2012-10-18_Transcript_Houston.pdf

Public Company Accounting Oversight Board (PCAOB). 2014a. *2014 PCAOB Annual Report*. Washington, DC: PCAOB.

Public Company Accounting Oversight Board (PCAOB). 2014b. *Public Company Accounting Oversight Board Strategic Plan: 2014–2018*. Washington, DC: PCAOB.

Public Company Accounting Oversight Board (PCAOB). 2015. *Firms That Failed to Address Quality Control Criticisms Satisfactorily*. Available at: http://pcaobus.org/inspections/reports/pages/firmsfailedtoaddressqcsatisfactorily.aspx

Securities and Exchange Commission (SEC). 2001. *Cautionary Advice Regarding Disclosure about Critical Accounting Policies*. Financial Reporting Release No. 60. Available at: http://www.sec.gov/rules/other/33-8040.htm

Securities and Exchange Commission (SEC). 2012. *Guidance for Consulting with the Office of the Chief Accountant*. Available at: http://www.sec.gov/info/accountants/ocasubguidance.htm

U.S. House of Representatives. 2002. The Sarbanes-Oxley Act of 2002. Public Law 107-204 [H. R. 3763]. Washington, DC: GPO.

UHY. 2011. *Re: Concept Release on Auditor Independence and Audit Firm Rotation*. PCAOB Rulemaking Docket Matter No. 037. New Haven, CT: UHY LLP.

WeiserMazars. 2011. *Re: Concept Release on Auditor Independence and Audit Firm Rotation. PCAOB Release No. 2011-006. August 16, 2011*. PCAOB Rulemaking Docket Matter No. 37. New York, NY: WeiserMazars LLP.

Whitehouse, T. 2013. *FASB to Require Troubled Companies to Fly a Red Flag*. Available at: http://www.complianceweek.com/fasb-to-require-troubled-companies-to-fly-a-red-flag/article/301692/