Southwestern Business Administration Journal
(SBAJ)
ISSN: 1554-7892
Volume 13 Issue 1&2, 2013, pp. 65-91

AUDITOR APPOINTMENT: WHO SHOULD APPOINT AND PAY THE AUDITOR?

Brian Jeter, University of Nebraska at Omaha, NE

Jack Armitage, University of Nebraska at Omaha, NE

ABSTRACT

This paper outlines the current system of how audit firms are appointed for publicly traded companies, highlights the current discussion of requiring mandatory audit firm rotation, and then explores alternative possibilities as to the appointment and payment of audit firms to audit public companies. The alternatives being evaluated include audit fees paid to an SEC fund which then distributes funds to audit firms, the SEC appointing auditors, stockholders appointing auditors, the stock exchange appointing the audit firm, and financial statement insurance. The PCAOB held discussions to evaluate whether there is sufficient auditor independence and professional skepticism in the current auditor appointment system. The PCAOB mainly focused on the effects of requiring mandatory audit firm rotations; however, this alternative is unpopular both in the private sector as well as with audit firms. Therefore, this paper seeks to identify feasible alternatives to mandatory audit firm rotations that can also be considered in order to identify a better method of appointing and paying audit firms that audit public companies.

Keywords: auditor appointment, auditor payment, audit firm rotation

INTRODUCTION

Many different groups of stakeholders of a company are users of audited financial statements (e.g., stockholders, regulators, investors, banks, financial analysts, suppliers, customers, etc.). These stakeholders use the information the company's management prepares to make business decisions. Stakeholders "…take very seriously the role of audited financial statements and rely on them for their integrity," which is why it is extremely important the financials are reliable (Bazerman, Morgan, and Loewenstein, 1997). Since corporate executive compensation plans are often tied to reported financial results, management has an obvious incentive to paint the company's financial position in the best light possible. To combat management's motivation to be optimistic, external stakeholders look to the reports of independent auditors to gain assurance management's financial statements are reliable. Because of management's incentives, the U.S. Securities and Exchange Commission (SEC) and the major stock exchanges require an audit by an external audit firm for publicly traded companies.

If the public is to have faith in audit services, the audit environment needs both actual and perceived independence. Human nature tells us that when one party pays for services provided for the benefit of others, there is likely an alignment of interests between the party paying and the party providing the services, which can act as a detriment to the others relying on the service. This alignment of interests raises the question of whether the party being paid can ever truly be independent, which standards require, or if independence is inherently impaired simply because the client pays the auditor. Stanford University professor Maureen McNichols questioned how independent an auditing firm can be when its job depends on the client. "When a firm hires its auditor, it is hard for the auditor to be truly independent … Audit firms speak of the companies they audit as their clients. When you look at the Web sites of public accounting firms, you see language that describes how their purpose is to provide value to their clients and to build relationships, to help clients solve complex business problems and enhance their ability to build value. I believe public accounting firms were created to serve a different client, the investing public" (Accounting Today, 2012).

The current system of appointing auditors has come under scrutiny from regulators. The Public Company Accounting Oversight Board (PCAOB) recently undertook an exploration of the need for mandatory audit firm rotation with its issuance of the *Concept Release on Auditor Independence and Auditor Rotation* (PCAOB, 2011). The PCAOB concluded that the evidence from PCAOB inspections of audit engagements led the Board to consider additional measures to protect auditors' independence. This issue is also being examined in the UK and Europe. UK's Competition Commission (CC) has expressed concern that the relationship between auditors and company management has become too comfortable with a tendency for auditors to focus on satisfying management rather than shareholders' needs (BBC News, 2013). The chair of the Audit Investigation Group of the CC stated that "We have found that there can be benefits to companies and their shareholders from switching auditors…" (BBC News, 2013). In Europe, the process of establishing audit firm rotation is gaining traction in several countries and some European countries are already embracing audit firm rotation.

Currently there is an array of rules and standards that are made to thwart these independence issues in the auditor payment model. Despite all the rules that are intended to promote auditor independence, audit deficiencies still exist in many areas. A lack of appropriate professional skepticism on the part of the auditor appears to be the main driver of the deficiencies. The absence of skepticism can be linked to many factors, one of which may be the auditor's disincentive to challenge management judgments for fear of losing a client and, therefore, revenue. Skeptics believe that while auditors may want to do the right thing, no auditor wants a displeased client or to be the reason their firm lost a long standing audit engagement, particularly if the sources of disagreement do not have crystal clear answers (Ferguson, 2011).

Has the current system achieved its purpose? Can it possibly achieve its purpose in the current environment? Should alternatives be evaluated to mitigate/negate the inherent risks of allowing clients to pay for audit services? The purpose of this paper is to highlight the current discussion requiring mandatory audit firm rotation, outline the current system of how audit firms are appointed for publicly traded companies, and then to explore alternative possibilities as to who should appoint and pay the audit firm. The alternatives being evaluated in this paper include audit fees paid to an SEC fund which then distributes funds to audit firms, the SEC appointing auditors, stockholders appointing auditors, the stock exchange itself appointing the audit firm, and an insurance company that provides insurance on an entity's financial statements selecting the auditors.

MANDATORY AUDIT FIRM ROTATION

There are strong opinions on both sides of this issue. Peter Clapman, Chief Counsel of Teachers Insurance and Annuity Association - College Retirement Equities Fund (TIAA-CREF) explains, "At our portfolio companies, we have been concerned about "embedded" auditor relationships, in which there has been a very long-term relationship with the auditor…We have had strict policies in place for many years with regard to audit firm rotation…Rotation of TIAA-CREF's external audit firm is formally considered between the fifth and tenth years of service, a policy in place for over 30 years" (Clapman, 2003). Speaking against mandatory audit firm rotation, former SEC Chairman Roderick Hills testified to the U.S. Senate, "Forcing a change of auditors can only lower the quality of audits and increase their costs. The longer an auditor is with a company the more it learns about its personnel, its business, and its intrinsic values. To change every several years will simply create a merry-go round of mediocrity" (Hills, 2002).

The passage of the Sarbanes-Oxley Act of 2002 (SOX) included a provision requiring the U.S. General Accounting Office (GAO) to study mandatory audit firm rotation. The GAO found that nearly 99 percent of Fortune 1000 companies do not have a policy to address audit firm tenure and 79 percent believe audit firm rotations increase the risk of audit failures. The average auditor tenure in the United States is 22 years and KPMG has audited General Electric for over a century (US GAO, 2003). Goldman Sachs has used the same auditor since 1926, Coca Cola since 1921, and Procter & Gamble since 1890 (Aubin, 2011).

Audit firm rotation is not a new idea. It has been discussed for many decades. Audit firm rotation was discussed as far back as 1939 when the SEC held hearings in the wake of the McKesson and Robbin's Inc. financial scandal (Journal of Accountancy, 1967). In 1977 the Metcalf Report recommended mandatory audit firm rotation to address the independence concerns caused by lengthy association between audit firms and their clients (Metcalf Report, 1977). Although the Cohen Commission sponsored by the American Institute of Certified Public Accountants (AICPA) rejected audit firm rotation in its final report in 1978 based on cost benefit considerations, they considered rotation for independence protection and providing a fresh start (Cohen Commission, 1978). Audit firm rotation was again considered in the Sarbanes-Oxley Act of 2002. Congress charged the GAO to examine issues surrounding audit firm rotation. In the final GAO report issued in 2003 the idea of audit firm rotation was rejected, but concluded that the PCAOB would need several years of information on the effects of SOX as it was passed before determining if additional measures would be necessary.

On March 16, 2011, AIG urged the PCAOB to consider mandatory audit firm rotations stating that the root concern about independence was a sense of "coziness" the audit firm had with management. AIG members stated that long running audit relationships were the cause of "coziness" with management. The concern with such long relationships between a publicly traded company and their auditor is that the auditors will no longer exhibit adequate professional skepticism because they will be predisposed to side with management, thus not being independent (McHugh III and Polinski, 2012). This concern is nothing new; in 1985, U.S. Congressman Richard Shelby asked during a session of the U.S. House of Representatives, "How can an audit firm remain independent…when it has established long-term personal and professional relationships with a company by auditing that company for many years, some 10, 20, or 30 years?" (Arel, Brody, and Pany, 2005)

A famous example of a long-term audit-client relationship where independence was compromised is the case of Arthur

Andersen and Enron. The relationship between Arthur Andersen auditors and Enron management and employees was so close that Arthur Andersen auditors had permanent offices at Enron's headquarters, celebrated birthdays with Enron employees, attended Enron charity fundraisers, and even went on the "Enron Employee" ski trips. According to former Enron accounting department employee Kevin Jolly, "People just thought they were employees." (Herrick and Barrionuevo, 2002)

Some have suggested empirical studies show that fraud is more likely to occur in the early years of an audit firm engagement (Carcello and Nagy, 2004). However, the PCAOB has not been able to make a correlation between auditor tenure and audit deficiencies due to inherent limitations and selection bias as the PCAOB typically only reviews risky engagements.

In August 2011, the PCAOB issued a concept release to solicit comments from the public concerning how auditor independence, objectivity, and professional skepticism could be enhanced. Specifically, the board sought advice and comment on mandatory audit firm rotation or suggestions of other approaches that may be superior.

The release goes on to state SOX has made a significant, positive difference in the quality of public company audits. However, the PCAOB is still uncovering instances where auditors are using neither independent and objective standards of care nor exercising sufficient professional skepticism. Therefore, the PCAOB is exploring other avenues that could foster a more independent relationship between the audit firm and the client. The most emphasized alternative by the PCAOB is a requirement of mandatory audit firm rotation. Proponents of this approach contend that it would free the auditor, to a high degree, from the pressures of management and offer a fresh view of a company's financials and accounting practices. Opponents contend that such an approach would increase costs of the audit engagement as new audit firms take time to learn the client's business and financial systems. Also, the quality of the audit may suffer due to this learning curve. The PCAOB recognizes that requiring audit firm rotation would significantly change the landscape of audit engagements and could potentially increase the cost and risk disruption (PCAOB, 2011).

The PCAOB is also considering a pilot program for mandatory audit firm rotation. Since there is little empirical data related directly to mandatory audit firm rotation (simply since it is not required in the U.S.) a test program that requires such a rotation could provide valuable data into this independence enhancement approach. The PCAOB may consider looking to Europe, where the process of establishing audit firm tenure (i.e. rotating the audit firm every seven years) is gaining traction in several countries. There are two major routes for this "retendering" as it is called; Option 1 gives the corporation the option to keep the current auditor at the end of the audit tenure and renew the tenure, and Option 2 "mandatory retendering with comply or explain" requires the corporation to select another audit firm at the end of the current audit tenure, or explain why appointing a new audit firm would be unfavorable. Some European countries are already embracing audit firm rotation. France makes it mandatory to rotate audit firms every six years, while Italy utilizes a form of retendering after seven years (Hoffelder, 2012).

The authors examined a sample of several dozen comment letters about audit firm rotation submitted to the PCAOB's docket 037 request. These letters show public companies oppose the idea of mandatory audit firm rotation very strongly. Most companies point to a "cost-benefit" analysis in which they believe the costs outweigh the benefits, i.e., audit fees would increase. Another common criticism is that mandatory auditor rotation would limit the field of possible audit firms to take over the engagement and some geographical locations would further limit the selection of on-sight auditors. In this sample, we did not find any suggestions from public companies of alternative solutions to increase auditor independence.

The "Big 4" audit firms appear to have the same views as the public companies. They do not feel that mandatory audit firm rotations are necessary. However, the "Big 4" audit firms went into much more detail to support their claims. Deloitte submitted two exhibits (shown in Exhibit A), one that showed financial statement restatements have declined from 555 in 2005 to 112 in 2011, while the other showed that class action lawsuits for accounting related issues has also declined from 130 in 2002 to 46 in 2010 (Deloitte, 2011). They used this data to support that the post SOX environment has been conducive to improving auditor independence. The audit firms also commented on support for less radical environmental changes such as adjustments to practices and building upon SOX's framework to provide increased independence.

In the comment letters sampled there was an overwhelming opposition to the mandatory audit firm rotation concept. Of the comments that opposed rotations, only very general and broad alternative solutions were suggested as to how to improve independence and professional skepticism. However, some comment letters indicated their support and encouragement of the PCAOB to explore additional alternatives. There were a number of letters supporting audit firm rotation, but those were primarily from individual CPAs citing their experiences working on audits of public companies to identify cases where the firm chose to not challenge the client on faulty accounting in order to keep the client.

CURRENT SYSTEM

The current system of hiring and firing auditors in the U.S. is covered in this section. Although independent auditors examine the financial statements prepared by management on behalf of the external stakeholders, the management of the company that prepared and issued the financials hire, fire, and, most importantly, pay the auditors or have significant influence over the audit committee making the audit firm choice. The company under audit may fire and hire a competing audit firm at will. However, "…their product is really for use by the public, to whom they owe a standard of care" (Haber, 2005).

Some contend that "under current institutional arrangements, it is psychologically impossible for auditors to maintain their objectivity…" and "audit failures are inevitable, even with the most honest auditors" (Bazerman, Morgan, and Loewenstein, 1997). On the other hand, others argue "…audits have improved and frauds are much rarer than in the past" and modifications to the current system are unwarranted (Aubin, 2011).

Some of the short comings of the current system involve moral hazard where management has an incentive to exert less effort, extract greater rewards, seek overly risky activities, and avoid risky but potentially rewarding activities. This may result in management appointing auditors that do not ask many questions, do not question management's judgment decisions, and are essentially easy to get along with and lenient on management. Management may be willing to accept a higher audit engagement fee for auditors that do not question management's accounting practices. A case-in-point is Enron, where "the audit fees paid to Andersen by Enron represented a substantial portion of…revenue." Therefore, it would not be unreasonable to "…infer that Andersen's independence would be questioned simply because of the size of the … fee[s]" (Haber, 2005). This may result in the dual negative effect for stakeholders of paying an above-average engagement fee and receiving financial statements of below-average reliability.

Also, self-serving bias presents another deficiency when management appoints auditors. Auditors do not personally know the stakeholders of the company's financial statements. Many stakeholders may lose money in the future, but those victims are only statistics to the auditors. On the other hand, the auditors are very well acquainted with management who may be hurt immediately by a negative opinion. Psychologically, people tend to be less concerned about harming statistical victims than ones they know (Bazerman, Morgan, and Loewenstein, 1997). Auditors may also unknowingly adapt, or get used to, small imperfections in the client's financials which may be an argument in contradiction of the reliance on studies that support audit effectiveness simply due to fewer accounting frauds being uncovered the longer an audit firm audits a client. Also, auditors may rationalize to themselves about the accuracy of their judgments. Therefore, auditor's judgments are likely to be unintentionally biased in favor of their own and their clients' interests (Bazerman, Morgan, and Loewenstein, 1997).

To put this into layman's terms, think of a used car salesperson that uses his or her own mechanic for customers to rely upon. The car mechanic is supposed to support and represent the buyer's interests and concerns. However, in this example the salesperson is the one that recruits, evaluates, hires, fires, pays, and ultimately decides whether to continue to use the mechanic for recommendations. Since the mechanic would not have an incentive to question the integrity of the salesperson's automobiles, the mechanic would try to get along with the salesperson due to the fact that they attest to all of the vehicles the salesperson sells and the salesperson would be willing to accept a higher price for a mechanic who is more submissive and sides with the salesperson (moral hazard). Since the mechanic does not personally know the customer but is very well acquainted with the salesperson, the mechanic would have a bias toward the salesperson since the mechanic's opinion is not immediately tangible in regard to the customer (mechanical problems might not occur for several months) but a negative opinion would immediately affect the salesperson (self-serving bias). Not to mention any unfavorable opinions rendered by the mechanic would most certainly be his or her last. No informed consumer would accept a mechanic chosen by the salesperson, but currently it is perfectly acceptable for management to select the auditor of their financial statements.

Finally, increased competition within the auditing profession, fueled by pressure to increase revenues, has led to "low-balling" audit fees for the first few years in order to steal accounts from other audit firms (for example see: O and Wang, 2007; Jensen and Payne, 2003; and Garsombke and Armitage, 1993). This provides motivation for auditors to retain the client for several years in order to recoup the loss in the early years, which leads to a favorable bias (Zeff, 2003). This favorable bias may come in the form of accepting aggressive accounting decisions, turning a blind-eye, not following up on issues, etc. Also, audit firms would have a bias toward spending fewer audit hours on the engagement in the first few years to negate some of the losses and costs.

These deficiencies justify looking at alternative methods of appointing and compensating the auditor in order to identify if the short comings mentioned above can be eliminated or at least reduced. Since there is a strong opposition to requiring mandatory audit firm rotations, the remainder of this paper will explore other possible alternatives to the current audit firm appointment system.

ALTERNATIVE 1: SEC FUND/POOL

The simplest and least ground-breaking alternative is to continue to allow the client's management to appoint the audit firm, but instead of the company paying the audit firm directly they would pay their audit fees to the SEC who would then distribute the funds to the audit firm. This creates a degree of separation. An easy way to conceptualize this is to think of your credit card payment. You go to the grocery store and make a purchase. When you pay your credit card bill, you do not send a payment to the grocery store, you pay the credit card company. The results of a study conducted by Elizabeth C. Hirschman (1979) showed that consumers are likely to spend more on purchases when using a credit card than when using cash. This may be attributable to consumers rationalizing the purchase because they have created a psychological level of separation from the company from which they are making the purchase. The same concept would hold true for this alternative. (1) The client and audit firm reach an agreement on the audit fees, (2) an agreement with audit fees charged is submitted to the SEC by the audit firm, (3) the SEC bills the client, (4) the client pays the SEC, (5) the SEC remits the payment to the audit firm.

The pros for this concept are the audit firm does not receive payment directly from the client. This creates an extra degree of separation from the audit firm and the client. If the audit firm does not see the client's name on the check they are depositing, perhaps they are less likely to associate with the client and reduce the self-serving bias. Also, this will make it clear and transparent to the SEC what the client is paying to the audit firm and, more importantly, for what types of services. This could provide even more detail regarding the audit fee than is currently disclosed to the SEC and may allow the SEC to more easily identify if low-balling is taking place.

The cons for this concept are that it does not address the moral hazard issue with management or motivate them to be diligent with whom they appoint as their auditors. Also, many may argue that this will not reduce any auditor bias since technically they are still employed and paid by the client. This will also increase the SEC's role, which might lead to inefficiencies by adding an extra party to the transaction. Little experimental research has been conducted on this alternative, which limits its viability. Possible future research areas may include questionnaires to senior managers, auditors, and CPAs to gain an understanding of their thoughts and perceptions toward this alternative.

ALTERNATIVE 2: SEC APPOINTMENT

A step beyond having the SEC pay the auditors is to have the SEC appoint and pay the audit firm. This would completely relieve management from the duty of hiring, firing, and paying auditors for an engagement. Under this method, the SEC would open a company's audit engagement up for bid and allow audit firms that are qualified to perform the audit to place a bid on the job, similar to how audits are now bid, except the presentation would be to the SEC. When an audit firm places a bid on the engagement, the firm will need to indicate why it is qualified to conduct the audit, indicate the experience the firm has in the industry, and disclose any previous services that have been provided to this client. The SEC would then select the best audit firm from the pool of applicants and price the engagement at what other engagements charge for similar industries and company size. The company may protest the audit firm selection, but a reasonable reason would need to be supplied in order to be considered.

A study by Sori and Karbhari (2005) examined the views of Malaysian auditors, loan officers, and senior managers of publicly listed companies. The survey found that the majority of loan officers and senior managers of publicly listed companies believed that audit firm rotation would safeguard independence, but the auditors disagreed with both groups and believed that rotation would threaten independence. The results further indicated that all three groups agreed that rotation of audit partners safeguarded auditor independence.

The advantages for the SEC appointing and paying the auditors are that it will completely eliminate the moral hazard involved in selecting an audit firm. "Having the… [SEC]…be responsible for hiring and paying the auditors would remove the potential for independence impairment" (Haber, 2005). Management has no say in who will be checking their financials, does not have an option to pay the auditor more to accept an aggressive accounting decision, and prevents both the client and the auditor from becoming too comfortable with each other in the engagement. In fact, the SEC could give the audit firm an incentive for uncovering fraud or identifying overly aggressive accounting decisions the client practices. Also, the self-serving bias in favor of the client's interests will be eliminated except for the bias to not hurt management personnel they have come to know personally during the course of the audit. The auditor will no longer have an incentive to simply give in and agree to management's accounting practices. This will also eliminate low-balling and endorse the most qualified audit firm to bid on the audit engagement.

A possible reason against this concept is the pricing. If the SEC is effectively setting the price, the audit firms might contend they are not being compensated adequately, while the clients might contend the prices are too high. However, efficiencies may be gained since employees will be hired at the SEC to specialize in the evaluation of the most qualified audit firm, rather than a select few employees at every audited company making an unspecialized, inexperienced evaluation of audit firm candidates. This would effectively centralize the auditor appointment process. Senior managers and auditors disagree, however. In the paper by Sori and Karbhari (2005), they noted that 82% of senior managers and 72% of auditors they surveyed believe auditor independence would be threatened if a regulatory body was given the power to appoint auditors. Other arguments against this method could include increased regulation, increased costs to support the SEC, and further complication of the audit firm selection process.

ALTERNATIVE 3: STOCKHOLDER APPOINTMENT

Another alternative, similar to allowing the SEC to appoint the auditor, is allowing the stockholders to vote on which auditing firm should be appointed based on recommendations from a stockholder committee. This, again, places the auditor selection into the hands of a third party. However some argue that all investors and creditors, not just the stockholders of the company, are the auditor's true clients. Since the auditors are trying to mitigate the principal-agent problem within a company, allowing the principal to be in charge of appointing the auditor is the main argument for this alternative. The main premise of the principal-agent problem is that the agent (management) is going to make the decision that most benefits them rather than the principal (stockholder) who hired them. Allowing management to select who reviews their work, rather than the stockholders, only further complicates the principal-agent problem.

A process, similar to the one outlined for the SEC appointment alternative, would need to be instituted where stockholders would need to be given a ballot with each of the recommended audit firms and a résumé for each firm. Stockholders would then need to evaluate each audit firm based on their credentials and vote (one vote per share they hold) for who they view would be the most qualified independent audit firm (Turnbull, 2008, pp. 43-44).

The advantages of this alternative are similar to the SEC appointment alternative and include reducing moral hazard as it relates to auditor selection. Auditor selection is placed in the hands of the stockholders, and management would no longer be able to appoint or influence the hiring of "push-over" auditors. Also, since auditors are meant to serve the stockholders and thereby help mitigate the principal-agent problem, it only makes sense to allow the stockholders to select the auditors. This concept is already practiced in some European countries where auditing conflicts, like the ones encountered in the U.S., are avoided when "…the auditor is selected, engaged and remunerated and reports to a shareholder panel" or watchdog board (Turnbull, 2008, p. 36). Since the auditor's true focus will be on the stockholder that appointed them, they will try to do what is best for them rather than management who no longer has the power to fire the auditor. This should also reduce the self-serving bias since the auditors have no incentive to give in to management's weak support for questionable accounting decisions.

The disadvantages of this alternative are that the largest shareholders would have the most say and possibly discourage small shareholders from even voting, a shareholder may hold shares in many different companies and be inundated with ballets for auditor appointment selections, voter turnout may be extremely low because some small shareholders may question the importance of their votes, and some shareholders may not have the expertise to evaluate audit firms. Also, stockholders may not even evaluate the audit firms and just select the lowest audit engagement fee. This may in fact make low-balling an even larger issue.

Some would argue that we already have this system in place in the U.S. as a result of SOX requirements for audit committees. For public companies, audit committees now are required to be in charge of the hire/fire decision for the auditors and to oversee the audit process. Additional considerations are that audit committees are representatives of the stockholders, not stockholders themselves, but also, audit committee members must be financially literate with one being a financial expert, so they would be much more knowledgeable than many stockholders. This option is different than the current system, though, because it would add another layer between the company and the audit firm selection process without having the audit committee (which is still part of the board of directors and works with management on a continuing basis) select the auditors.

ALTERNATIVE 4: STOCK EXCHANGE APPOINTMENT

Another alternative is to allow the stock exchange, where the publicly traded company's stock is traded, to appoint the audit firm. The U.S. Federal Reserve Bank and its bank examiners can provide a good model for how this method can be used. The Federal Reserve Bank employs bank examiners who have the task of making sure that chartered banks are operating legally, ethically, and within the requirements that make it possible to conduct business. Bank examiners are concerned with several key requirements. "Examiners assess the financial institutions to determine the existence of unsafe and unsound practices, violations of law and regulation, the adequacy of internal controls/procedures and the general character of management. Examiners write comments and analyses for inclusion in reports of examination and meet with insured depository institution officials, including the board of directors, to discuss the findings of an examination and, if necessary, to institute any corrective programs" (What We Do, 2008). A study of bank examiners by Robert DeYoung et al. (1998) supports the concept that bank examiners can produce value-relevant information about the safety and soundness of banks. But would this be equivalent to a stock exchange assigning auditors to examine companies that are listed on their exchange?

Just like how the Federal Reserve assigns bank examiners to examine banks that are chartered with them, the New York Stock Exchange (and other exchanges) would assign audit firms to audit the publicly traded companies on their exchange. Each exchange would be in charge of the companies that they list. This system has proven effective in examining banks, given that no bank depositor has lost one cent of FDIC insured funds since the 1930s (When a Bank Fails, 2010). This could also pave the way for a rating system similar to the Morningstar rating system for stocks, but instead of rating stocks, the system would rate each stock exchange on how safe the companies are that list on their exchange.

The advantages of this alternative include reduced moral hazard (since management will not appoint the auditors), reduced self-serving bias (since the auditor will not simply be trying to please management because they no longer hire/fire the audit firm), and it will also reduce low-balling (since the stock exchanges would have an incentive to select the most qualified, impartial audit firm available). "Having the stock exchange…be responsible for hiring and paying the auditors would remove the potential for independence impairment" (Haber, 2005). Audit firms would be paid by their clients whose financials they audit, but would report to and serve the stock exchange. A side effect of this alternative is that stock exchanges will want to identify and prevent companies that pose a substantial financial reporting risk from being listed on their exchange so those companies do not tarnish the exchange's reputation.

The disadvantages of this alternative include added complexity of auditor appointment, a bias to please the stock exchange so the audit firm can get hired onto additional audits for that exchange, and the stock exchange having too many audit firms to appoint that they revert to the preference of the company's management. These issues can be reduced if the stock exchange is willing to do their due diligence and if enough weight is put on the stock exchange rating system.

ALTERNATIVE 5: FINANCIAL STATEMENT INSURANCE

The final alternative examined would be a system of requiring companies to obtain insurance on their financial statements. Under this alternative the auditor is retained by the insurance carrier that issues the insurance policy. The process would start with the potentially insured company requesting a review by an insurance carrier. The result of this review would be the carrier informing the company the maximum amount of insurance they would offer and the related premium. The company's stockholders would then vote on accepting the maximum amount of insurance and premium being offered, a lesser amount of insurance recommended by management, or no insurance. Based on the vote of the shareholders, the insurance carrier would select the auditor and establish the scope and depth of audit which the auditor must satisfy. If the auditor issued a clean opinion, the insurance carrier would issue the policy. If the opinion was modified, the company would need to negotiate different terms with the insurer (Ronen and Cherny, 2002).

Insurance carriers should be interested in this type of coverage. In assessing the potential insured's risk, the carriers would have available current, audited financial statements, and since the insurance carrier hires and controls the auditor, the carrier could direct the auditor to obtain the specific type of information necessary to reach their decision (Moody, 2004). Auditors and public corporations should also not have objections to work within this type of system. Financial statement insurance would not effect the scope and amount of audit work available, although as with alternatives 2 and 4 the auditor would need to get used to working for a new boss (the insurance company).

Advantages of a financial statement insurance system is alleviation the problems of moral hazard, self-serving bias, and low balling. The inherent conflict of interest between management of the company being audited and the auditors would be eliminated because the insurance carrier is hiring and paying the auditor. This would give the shareholders and creditors an extra level of assurance that the financial statements can be relied upon. Also, the publication of the available levels of insurance available as well as the premium would be an additional signal to the market in making investment choices. Riskier companies would pay higher premiums than less risky ones. For example, if a company had a small amount of coverage with a high premium, the investors could better gauge the likelihood of recovering losses due to fraud and the risk of investing in a particular company. Additionally, this system would not require additional governmental regulations as everything would be in the private sector.

A significant disadvantage of this alternative may be that it is such a drastic departure from the current system of auditors' expressing an opinion on the fairness of financial statements to be used by investors and creditors. With this approach the auditor would be primarily providing information to the insurance carrier to make a risk assessment, rather than providing an audit opinion for the general use of investors and creditors. This may impact potential students considering studying accounting and auditing and it may generate a negative reaction from auditing standard setters and regulators. As well this proposal has generated significant discussion in the legal literature regarding shareholder compensation for accounting fraud (Evans, 2007).

CONCLUSION

In conclusion, this paper highlighted the current discussion of requiring mandatory audit firm rotations, outlined the current system of how audit firms are appointed, and then explored several alternatives involving who appoints audit firms. Since management has an incentive to make themselves look good, and auditors have an incentive under the current system to please the company that appoints them so they keep the audit engagement, there is an obvious need to evaluate alternatives that can potentially improve the effectiveness and reliability of audits. Since there is an overwhelming opposition to the currently debated mandatory audit firm rotation by the private sector and audit firms, this paper sought to identify other alternatives. The first alternative involved establishing an SEC fund that companies pay their audit fees into and are then distributed to the audit firm. The pros for this concept are that it creates a degree of separation between the client and the audit firm and could reduce self-serving bias but does not address the moral hazard issue and in the end the company still pays and appoints the audit firm. The second alternative proposed involved the SEC appointing and remitting payment to the audit firm. Advantages for this concept included reduced moral hazard, self-serving bias, and low-balling but has issues with audit pricing, its effectiveness, and increased size/role of government. The third alternative involved the stockholders electing and appointing the audit firm. The pros for this concept included reduced moral hazard, principal-agency problem, and self-serving bias but included cons such as the largest stockholders would have the most say, few stockholders might actually vote, and stockholders may just pick the cheapest audit firm which would increase low-balling problems. The fourth alternative involved having the stock exchange where the publicly traded company is listed appoint the audit firm. The advantages for this concept included reduced moral hazard and low-balling, but has deficiencies in auditor bias toward the stock exchange, stock exchanges having to appoint too many audit firms, and added complexity. The final alternative involved companies obtaining financial statement insurance. This alternative's advantages include reduced moral hazard, self-serving bias, and low-balling as well as being a private sector solution, but would require the most significant changes to the current system.

PCAOB chairperson James Doty stated "…auditors face real pressure to please their clients" and he indicated as well that the PCAOB too often discovers that auditors do not exercise the appropriate level of skepticism. He went on stating that "an audit has value to the public only to the extent that it is performed by a third party who is viewed as having no financial stake in the outcome" (Polimeni and Burke, 2011).

We are not suggesting that auditors are corrupt or unethical, but that auditors are put in a very difficult position because they are paid by the company that hires them. Management has an obvious incentive to paint the company's financial position in the best light possible; therefore, it only seems logical that management's bias should be mitigated the best way possible. The current auditor appointment system is not conducive for providing such mitigation as it is psychologically impossible for auditors to maintain their objectivity. Allowing companies to select, pay, negotiate with, and fire audit firms only seems to exacerbate their biases and put shareholders at risk of relying on subpar financials.

Over time, auditors unknowingly adapt or get used to small imperfections in clients' financials. If the auditors have some questions on accounting practices and the company has an aggressive but acceptable stance on the situation, the auditors are likely to learn from that situation and apply it to future situations. While management's stance could be determined to be acceptable, it could still fall into a grey area. The next time the auditors evaluate that situation, they are likely to look at their audit notes from the prior year and make the same conclusion (barring any changes to management's stance) without additional in-depth analysis of the situation that occurred the first year. Year-after-year the auditors come to the same conclusion as they always have until there comes a point where the auditors have accepted the answer for a decade, which makes it nearly impossible to not accept management's stance due to the precedence they have set by accepting it for so many years. If auditors adapt to management's stance after years of audits, we believe this contradicts the studies that support audit effectiveness increases as the audit tenure increases simply due to fewer accounting frauds being uncovered the longer an audit firm audits a client. Since the audit firm adapts to the small imperfections of the client over time, they are less likely to call into question those accounting practices as the audit tenure increases.

However, this does not mean that the first few years of an audit engagement are necessarily the most effective at uncovering deficiencies. If "low-balling" is occurs, auditors know they need to keep the audit for several years to make the engagement profitable. Therefore, auditors develop a favorable bias in order to not upset their client and guarantee additional audit engagements in the future. In addition, to keep audit costs down while the audit firm "low-balls" in the first few years, the audit firm would have an inherent need to keep audit hours at a minimum in order to reduce costs. Fewer audit hours lead to less business knowledge and testing. While nearly 80% of companies feel firm rotation would increase the risk of audit failures, it is not because first year audits are inherently risky and ineffective. It is because the current system is not conducive to a good audit. Given these reasons, we believe the current auditor appointment system needs to be altered in some form.

In order to unlock the best way to alter the current system, the industry needs to take a close look at the root problem. "Low-balling" limits the effectiveness of audits in the early years of the audit tenure. From there, auditor "coziness" (where auditors get used to their client's small imperfections in practices, rationalize the accuracy of their judgments due to the self-serving bias, and a "don't rock the boat" environment is cultivated) manifests itself once the audit firm has passed the "low-balling" period. Therefore, the current system is flawed both in the first few years of the tenure as well as after several years. In addition, moral hazard and self-serving bias hinder both managements' and auditors' decision making.

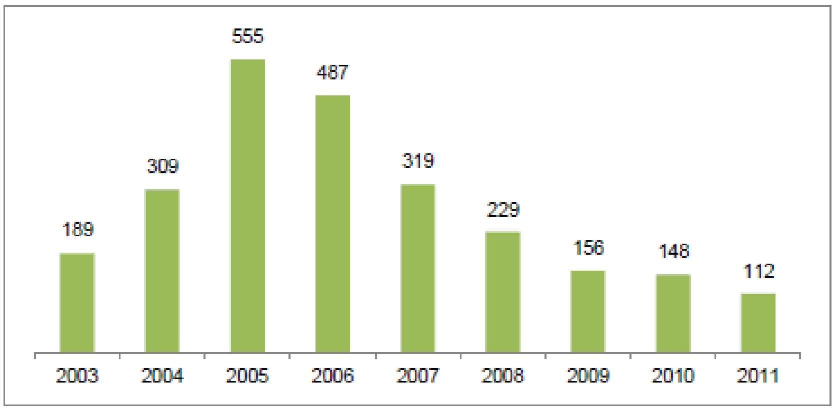
PCAOB's suggestion was to consider mandatory audit firm rotation. Although this approach would be a step in the right direction, this may not be the total solution. This alternative does not fully address the root issues. While audit firm rotation would require a new firm to audit the financials every several years to reduce the "coziness" between the auditors and management, "low-balling", moral hazard, and the self-serving bias may not be adequately controlled because management still has influential power over the audit firm, management still pays the auditor's salary, and they can fire the audit firm at any time. Many opponents of mandatory audit firm rotation contest that this approach would increase costs as new auditors take time to learn and understand the client's business and financial systems. Many companies utilize complex financial and business systems that can take years to understand. A new audit firm every several years will require many hours from management explaining the systems to the new auditors. Once they finally gain enough experience using the system, the audit tenure has ended and management has to explain everything over again to new auditors. While "coziness" may be reduced in this auditor appointment system, audit quality may still suffer due to these factors. However, following this logic, due to the steep learning curve audit firms should not be rotated. An organization should retain the same auditor for its entire existence, whether that be a century or longer. We believe that no one that is trying to seriously understand this issue considers that a good idea.

Regarding Deloitte's two exhibits (Exhibit A) and conclusion that the post-SOX environment has been conducive to improving auditor independence, their reasoning appears to have two fundamental flaws. First, the shake-up that ensued after the Enron and WorldCom debacles caused a lot of companies to reevaluate their situations. As a result, the early to mid-2000s saw an unprecedented jump in financial restatements (GAO, 2002). Therefore, the results Deloitte points to are artificial. Second, the graphs can also be used to support the argument auditors are becoming too "cozy" with management. Since it has been a decade since SOX was implemented, auditors have started to forget the severe consequences when they do not exercise the required standard of professional care. This attitude may have lowered auditors guard and the self-serving bias has taken over. The less auditors question management decisions, the fewer financial statement restatements.

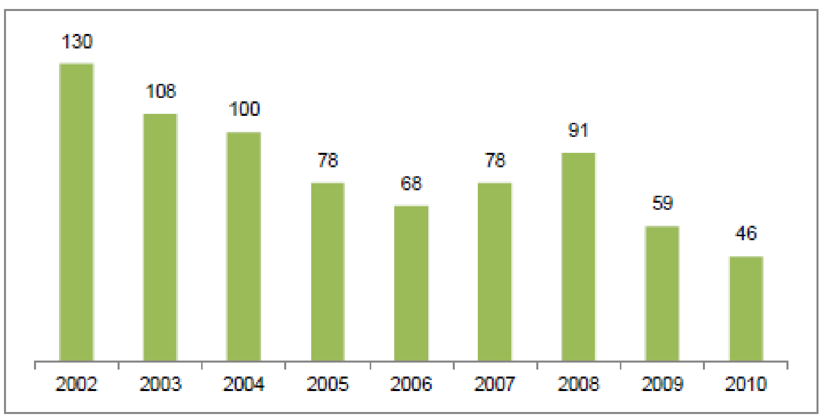
There is a clear need to change the current system in some manner. Managing partner at BDO UK Simon Michaels stated "No one solution will achieve market correction, but rather a combination of tendering [audit firm rotation] requirements, encouragement of transparency and dialogue between auditors, companies and investors, and reform of outdated exclusionary practices should provide a backdrop for a healthier … audit market," (BBC News, 2013). Due to the unpopularity of mandatory audit firm rotations, additional viable options should be explored. A new system has the potential to reduce the root problems in the current auditor selection and payment system.

Exhibit A

Financial statement restatements, 2003-2011



Class action filings including accounting-related allegations, 2002-2010



Source: Deloitte, 2011

REFERENCES

Accounting Today (2012). PCAOB Hears Further Debate over Audit Firm Rotation, June 29, 2012. Retrieved from http://www.accountingtoday.com/news/pcaob-mandatory-audit-firm-rotatation-63169-1.html

Arel, B., R.G. Brody, and K. Pany (2005). Audit Firm Rotation and Audit Quality. *CPA Journal*, 75 (1), 36-39.
Aubin, D. (2011). Decades-Old Auditor Ties Under Scrutiny in U.S. *Chicago Tribune*. August 3, 2011.
Retrieved from www.chicagotribune.com/business/sns-rt-us-usa-accounting-rtre7720mj-20110803,0,6013220.story

Bazerman, M. H., Morgan, K. P., & Loewenstein, G. F. (1997). The Impossibility of Auditor Independence. *Sloan Management Review*, 91-92.

BBC News, (2013). Competition Commission raps Big Four accountants, Business section, 22 February 2013. Retrieved from http://www.bbc.co.uk/news/business-21543945

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.

Clapman, P.C. (2003). Comment letter on the SEC's proposed rules on auditor independence (File No. S7-49-02). 13 January.

Coffer, E. (n.d.). Retrieved November 28, 2011, from Thinkexist Web site: http://thinkexist.com/quotation/people_who_bite_the_hand_that_feeds_them_usually/205085.html

Cohen Commission, (1978). The Commission on Auditors' Responsibilities: Report, Conclusions, and Recommendations. AICPA. Retrieved at http://c0403731.cdn.cloudfiles.rackspacecloud.com/collection/papers/1970/1978_0101_CohenAuditors.pdf

Deloitte. (2011). *Re: Request for Public Comment on Concept Release on Auditor Independence and Audit Firm Rotation.* Retrieved from http://pcaobus.org/Rules/Rulemaking/Docket037/163_Deloitte_Touche_LLP.pdf

DeYoung, R., Flannery, M., Lang, W., & Sorescu, S. (1998). *The Informational Advantage of Specialized Monitors: The Case of Bank Examiners.*

Evans, A.D., (2007). The Investor Compensation Fund. *Journal of Corporation Law*, 33 (1), 233-296.

Ferguson, L. H. (2011). *Concept Release on Auditor Independence and Audit Firm Rotation .* Washington, DC: PCAOB.

Garsombke, H., & Armitage, J. (1993). Competitive Bidding, Fees and Auditor Changes: Additional Evidence. *The Journal of Aplied Business Research*, 9(3), 93-99.

Haber, J. (2005). Does Being the Auditor Impair Independence? *The CPA Journal*, 75 (6), 12.

Herrick, T. and A. Barrionuevo (2002). Were Enron, Anderson Too Close To Allow Auditor to Do Its Job? *The Wall Street Journal*, January 21, 2002.

Hills, R.M. (2002). *Oversight Hearing on "Accounting and Investor Protection Issues Raised by Enron and Other Public Companies."* Senate Committee on Banking, Housing, and Urban Affairs. 107th Cong., 2nd sess. 12 February.

Hirschman, E. C. (1979). Differences in Consumer Purchase Behavior by Credit Card Payment System. *Journal of Consumer Research*, 58-66.

Hoffelder, K. (2012, May 11). *Transatlantic Divide Grows Over Audit Rotation.* Retrieved from CFO.com.

Jensen, K., & Payne, J. (2003). *Auditing Pricing and Audit Quality: The Influence of the Introduction of Price Competition.* Retrieved from SSRN: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=451500.

Journal of Accountancy, (1967). "Editorial: The Question of Changing Auditors." *The Journal of Accountancy*, 123 (2), 31-33.

McHugh, M.E., P.W. Polinski (2012). Audit Firm Changes Post-Sarbanes Oxley. *CPA Journal*, 82 (5), 24-31.

Metcalf Report, (1977). Staff of Subcomm. on Reports, Accounting and Management of the S. Comm. on Government Operations, 95th Cong.

Moody, M.J., (2004). Financial Statement Insurance: An Idea Whose Time Has Come. *Rough Notes*, 147 (11), 42-45.

O, S., & Wang, K. (2007). *Competition and Low-Balling: Evidence from Texas Municipalities.* Retrieved from http://www.jgbm.org/page/1%20Sewon%20O%20.pdf.

PCAOB. (2011). Concept Release on Auditor Independence and Audit Firm Rotation. *PCAOB Release No. 2011-006.*Available at: http://pcaobus.org/News/Speech/Pages/08162011_Dotystatement.aspx

Polimeni, R.S. and J.A. Burke, (2011). Auditor Independence? Time to Eliminate the Question Mark. *Journal of Portfolio Management*, 38 (1), 5-8.

Ronen, J. and J. Cherny, (2002). Can Insurance Solve the Auditing Dilemma? *National Underwriter*, 106 (29), 12-14.

Sarbanes-Oxley Act of 2002. Retrieved from http://www.sec.gov/about/laws/soa2002.pdf

Sori, D. Z., & Karbhari, D. Y. (2005). *Auditor Appointment, Rotation and Independence: Some Evidence from Malaysia.* Retrieved from SSRN: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=871140

Turnbull, S. (2008). Why Emerging Economies Should Not Follow US and UK Audit Practices. *ICFAI Journal of Audit Practice*, 36, 43-44.

U.S. General Accounting Office (GAO). (2002). *Financial Statement Restatements.* Retrieved from http://www.gao.gov/new.items/d03138.pdf

U.S. General Accounting Office (GAO). (2003). *Required Study on the Potential Effects of Mandatory Audit Firm Rotation.* Retrieved from http://www.gao.gov/new.items/d04216.pdf*What We Do.* (2008, October 7). Retrieved November 28, 2011, from Federal Deposit Insurance Corporation Web site: http://www.fdic.gov/about/jobs/do.html

When a Bank Fails. (2010, July 7). Retrieved December 6, 2011, from FDIC Web site: http://www.fdic.gov/consumers/banking/facts/index.html

Zeff, S. A. (2003). How the U.S. Accounting Profession Got Where It Is Today: Part I. *Accounting Horizons*, 202.

About the Authors:

Brian Jeter is a graduate of the bachelor's and MAcc accounting programs at the University of Nebraska at Omaha. After graduation Brian is working in public accounting.

Jack Armitage holds bachelors (University of Nebraska), masters (University of Wyoming), and Ph.D. (University of Nebraska) degrees in accounting. Professor Armitage teaches auditing at the undergraduate and graduate levels and has received university and college teaching awards. Professor Armitage's research interests involve auditing and accounting education issues. He has over 35 publications in academic and practitioner journals and over 30 presentations at academic meetings. In addition, Dr. Armitage has significant experience working with academicians and practitioners outside the USA.