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How Do Regulatory Reforms to Enhance Auditor Independence Work in Practice?*

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Though auditors should regard the investing public as their client, they tend to kowtow instead to the managers who choose them and dole out their pay. Whose bread I eat, his song I sing.

Warren Buffett (c.f. Buffett and Clark 2006)

1. Introduction

Securities laws mandate public corporations to hire an independent auditor. Since the advent of such mandates, there has been a concern that auditors face a potential conflict of interest because they are hired and paid by the companies they audit (Mautz and Sharaf 1961). It is a challenge for regulators to strike the right balance between the auditors serving commercial versus professional interests (Zeff 2003; Barrett, Cooper, and Jamal 2005; Humphrey 2008; Suddaby, Gendron, and Lam 2009). Although some observers have advocated changing the auditor appointment process so the company does not select its own auditor (Mayhew and Pike 2004; Moore, Tetlock, Tanlu, and Bazerman 2006), regulators have not adopted this recommendation. Instead, regulators have sought to promote auditor independence by implementing a set of alternative remedies, such as mandatory audit partner rotation and enhanced audit committee responsibilities, expertise and independence. At present, regulators in Europe and the United States are considering an extension of rotation requirements to encompass audit *firm* rotation, rather than *partner* rotation.

In this paper, we conduct a field study to investigate how regulatory reforms designed to promote auditor independence (specifically audit committee reforms and proposed audit firm rotation requirements) may actually work in the context of auditor change. The process of engaging auditors requires the prospective parties to exchange and evaluate information about each other. Theoretical analyses and regulatory reforms often assume that the relevant information is readily available — perhaps even common knowledge — to the contracting agents (Antle 1982). However, in practice there may be significant information asymmetries and power imbalances among agents that might hinder the objectives of regu-

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lators. As Hayek (1945) pointed out in his analysis of markets, regulators and individual decision makers acquire, aggregate, and interpret the relevant information required to make effective economic decisions. This information is dispersed among parties who have little incentive to reveal it for fear that such revelation may be injurious to their own interests. Information dispersal, power disparities between contracting agents (Cooper and Sherer 1984), and conflicts between private and collective interest, are “sand in the gear-box” of well-intentioned reforms. The issue at the heart of auditor independence debates is the concern that the auditor may advocate for management, rather than view the investing public as the client (Barrett et al. 2005; Buffet and Clark 2006; Jamal and Tan 2010). While concerns about auditors’ commercial (as opposed to professional) orientation have focused on the economic pressures that auditors face from clients’ consulting fees (Humphrey 2008; Zeff 2003), the fundamental conflict creating pressure for client advocacy (and treating management, rather than the audit committee, as the client) derives from the auditor appointment process (Mautz and Sharaf 1961; Humphrey and Moizer 1990). If management, with private information and interests, continues to have substantial influence over hiring the auditor, then regulatory reforms for audit firm rotation and/or audit committee empowerment are likely to be ineffective.

Before deciding whether and on what terms they should engage each other, auditors and prospective clients participate in a “courtship” to gather information about each other. Courtship involves the activities and behaviors in the period prior to a new engagement that culminates in an engagement decision.¹ We use the term courtship because the economic incentives in this setting favor the auditor and client working together in a cooperative relationship. Courtship also connotes some prior familiarity and screening between the parties involved and, hence, a cordial engagement process rather than an adversarial one. Regulatory reforms are designed to block this courtship process and make the auditor more independent of management by severing the economic and relationship bonds between the auditor and management.

We examine an auditor–client courtship process to better understand how and what information is collected by the parties involved, and the dynamic interplay between management, the board, and prospective audit firms. The courtship period provides an opportunity to observe the nuances of how auditors ascertain and respond to the relative roles and power of the audit committee vis-à-vis management. Our study of auditor change also yields insights into the potential consequences of increasing the frequency of auditor–client courtships through mandatory audit firm rotation, which has recently been proposed by regulators as a way of reinforcing auditor independence (European Commission 2010; Public Company Accounting Oversight Board 2011). The underlying premise is that audit quality would be enhanced by weakening the economic and relationship bonds between auditors and their clients.

Regulators have also placed their faith in audit committees to enhance auditor independence by mandating that the external auditor be appointed by an audit committee. The dominant view in both the academic literature (e.g., Beasley, Carcello, Hermanson, and Neal 2009) and professional guidance (e.g., American Institute of Certified Professional Accountants 2004) is that the audit committee “owns” the auditor appointment process and has primary responsibility for gathering relevant information and making the appointment decision. An alternative view is that these regulatory reforms leave in place power relations whereby management is the dominant party who hires both the auditor and the directors on the audit committee, and thus audit committee actions are likely to

1. We interpret the term courtship based on Western societal views of courting, which is a period where parties to a prospective relationship get to know and attract each other before deciding if they will enter into a more permanent relationship, such as engagement or marriage.

be ceremonial rather than substantive (Cooper and Sherer 1984; Cohen, Krishnamoorthy, and Wright 2010). We investigate how the audit committee interprets and executes its legislative mandate in appointing an independent external auditor.

Much remains to be learned about the efficacy of regulatory reforms for auditor independence. Cooper and Robson (2006) propose that institutions and sites of professionalism matter in understanding how rules and structural changes are implemented and legitimized in practice. We thus focus on the audit request-for-proposal (RFP) as a discrete event where we have the opportunity to study how auditor independence reforms are interpreted and implemented in practice. Because most records of auditor–management–audit committee interaction are private and rarely available to researchers, we conduct a detailed field study of an RFP process as a way of generating evidence on how these parties enact their respective roles in this event (Humphrey 2008). In our case study of a company that changed its audit firm, we examine auditor and client behavior in an event that is central to proposed audit firm rotation reforms. We also extend the literature on how audit committees work and to what extent they are influenced and/or controlled by management in a post-audit committee reform setting (Gendron, Bédard, and Gosselin 2004; Gendron and Bédard 2006; Beasley et al. 2009; Cohen et al. 2010).

We deliberately sought a large, profitable, public company to be the site of our case study. The company is governed by all recent regulatory requirements and appears to have a high quality audit committee (as conventionally defined in terms of independence, expertise, meeting frequency, and members' retainer premiums). The company's audit RFP process was triggered, in part, by an audit partner rotation requirement. The case thus presents the potential for the audit committee to demonstrate exemplary performance and provides an opportunity to observe the behavior of the Big 4 audit firms when they are faced with significant temptation; that is, the opportunity to acquire a prestigious, growing, and desirable client. If the client was not attractive, then the auditor would have little incentive to become an advocate for management. There is a countervailing force that promotes independence in this case study, because the company has a high-quality audit committee that could potentially take control of the auditor selection decision. The client is profitable, operates in a regulated industry, and has (what we argue is) a sophisticated audit committee. If an auditor were to become an advocate for management when faced with such conditions, then we doubt the generality and effectiveness of independence reforms. Furthermore, we question the potential for regulation to weaken auditor-management relationship bonds.

Because we are interested in understanding detailed internal processes where auditors, managers, and audit committee members interact with each other, and the power they have to exchange information and make decisions, we obtained proprietary data from one publicly listed company's RFP for audit services. Shortly after this organization engaged a new auditor, we interviewed individuals involved in the process (the chief financial officer [CFO] and audit committee chair of the company, and all prospective audit partners who bid) and examined documentary evidence of the company's RFP, the participating auditors' bids, and the board's deliberations. We examined minutes of audit committee and board meetings, as well as auditor evaluation scorecards completed by management and audit committee members. By obtaining in-depth access to key players and triangulating their accounts with confidential records of this phenomenon, our study responds to the need for research to examine accounting in action and describes the complexities of behavioral processes and organizational practices (Power 2003; Hopwood 2007; Humphrey 2008). However, due to the nature of the personal interviews, we caution that there are limits to participants' candor and our ability to probe and challenge their representations.

We observe limited involvement of the audit committee in the RFP process and auditor selection decision. The audit committee abdicates its information-gathering and decision-making responsibilities to management, serves as a witness to management's

procedures, and approves management's selection decision. Management is the main producer and gatherer of information, controlling what, when, and how information is distributed to the audit committee and auditors. The competing auditors' role in the RFP process is to decipher the decision-making authority in the company (whom all but the incumbent identified as the CFO), and to strategically offer information that responds to the decision maker's needs and preferences. All auditors also seek to convey some factor, beyond technical expertise, to differentiate themselves from other auditors bidding for the audit engagement. Our study raises doubts about the effectiveness of recent and proposed auditing reforms and suggests that they do not operate in the manner intended by regulators to enhance auditor independence. Instead of strengthening independence and providing a fresh auditor perspective, we find that the auditor change process is dominated by management and is characterized by gestures from prospective auditors to win client favor during the courtship, potentially rendering proposed audit firm rotation ineffective.²

This paper is organized as follows. The next section presents relevant literature and guidelines that contextualize auditor change in the RFP process. In section 3, we describe our research method. A detailed description of our primary case study follows in section 4. We analyze our observations in section 5. In section 6, we summarize our findings and conclude our discussion with implications for practice and future research.

2. Auditor independence in the context of auditor change

Prior literature on measures to enhance auditor independence

One central proposal considered by regulators to enhance auditor independence is to mandate audit rotation both at partner and firm level (Mayhew and Pike 2004; Humphrey, Kausar, Loft, and Woods 2011). Audit partner rotation is currently mandated by law, and recently the European Commission (EC) and the U.S. Public Company Accounting Oversight Board (PCAOB) have proposed to mandate audit firm rotation (PCAOB 2011; EC 2010). Rotation of auditors, whether another engagement partner from the same firm, or a different firm altogether, is supposed to bring a fresh set of eyes (Tan 1995), reduce auditor susceptibility to being led down the garden path by an unscrupulous client, and uproot entrenched relationships that may override auditor objectivity and independence. The accounting literature reports mixed evidence on auditor rotation reforms. While experiments indicate that some potential benefit of auditor objectivity might be obtained from auditor rotation (e.g., Tan 1995; Dopuch, King, and Schwartz 2001), other studies generally find no positive effect for auditor rotation mandates (e.g., Myers, Myers, and Omer 2003; Ruiz-Barbadillo, Gómez-Aguilar, and Carrera 2009) and some find negative effects (Beasley et al. 2009).

A key objective of audit committee reforms in Canada (see, e.g., Canadian Securities Administrators [CSA] 2004) is to enhance the audit committee's authority and make it responsible for appointing the external auditor.³ Assigning this responsibility to the audit committee acknowledges the committee's role in representing the investing public and engaging an independent auditor. Accounting literature related to corporate governance reforms presents mixed evidence on the role of the audit committee in auditor selection. Audit committee

2. We studied six other RFP proposals in the private and public sector, and we also interviewed a Big 4 firm partner in the United States, to provide evidence on the generalizability of our results. Data from only one company is presented in this paper, because it is the largest and most sophisticated organization and it provided us the deepest level of access. In the other six cases, we also observed management having a dominant role in the auditor appointment process.

3. *Multilateral Instrument 52-110 Audit Committees* (CSA 2004) has been adopted by securities regulatory authorities in the provinces and territories in Canada (except for British Columbia). According to MI 52-110, the rule on auditor appointment is similar to and derived from audit committee requirements in the Sarbanes-Oxley Act of 2002, the U.S. Securities and Exchange Commission, and New York Stock Exchange and NASDAQ listing requirements.

members interviewed by Beasley et al. 2009 describe active audit committee involvement in selecting a new engagement partner during mandatory audit partner rotation. However, Cohen et al. (2010) interview auditors and report the limited role of audit committees and the dominant role of management in making auditor appointment and dismissal decisions.

The regulatory intent of enhancing auditor independence underlies reforms for both auditor rotation and audit committee appointment of the external auditor, but the literature lacks compelling evidence of the efficacy of these reforms in practice. Our investigation of a change in a company's auditors through an RFP process provides detailed insight into the interpretation and implementation of these reforms.

Audit RFP guidelines for auditor–management–audit committee information exchange

Companies seeking a new external auditor through an RFP can consult professional guidance on this process. For example, the American Institute of Certified Public Accountants (AICPA) offers guidelines for preparing an RFP document and selecting an auditor (AICPA 2004).⁴ In addition, the Canadian national office of one Big 4 firm has published guidelines for audit RFPs (Audit Firm 2007). This guidance is congruent to the AICPA source, but describes more specific criteria and details for each step of the RFP process. Interviewees at the company in our study stated that they obtained and relied heavily on the Big 4 firm RFP guide to structure the auditor selection process, so we use this guide to contextualize our expectations and observations.

The audit firm RFP guide counsels organizations to define their objectives for seeking a new external auditor; establish logistical details for gathering and communicating relevant information; and specify metrics for evaluating prospective auditors. Table 1 outlines the practitioner guidance for a company's audit RFP process.

Several items in this RFP guide raise auditor independence concerns. The first set of concerns relates to recommendations about the process of audit procurement. The guide recommends that a project manager should control all collection and distribution of information, including access to people. Because the guide specifies that a member of company management should be the project manager, it puts management (rather than the audit committee) at the center of all data collection activity. The guide also recommends that a selection panel (which includes members of management and the audit committee) should make the auditor selection decision, rather than solely the audit committee. This measure diverges from regulations to empower the audit committee by providing management with formal and substantial influence over the auditor appointment process.

The second set of concerns relate to the auditor evaluation criteria set forth in the RFP guide. All discussions of “fit” are directed to the relationship between prospective auditors and management, and exclude the audit committee. Furthermore, absent is any advice for the company to provide internal private information necessary for auditors to understand audit risk. There is no mention of providing information about the quality of internal control; issues negotiated with the previous auditor; disagreements with the previous auditor; audit differences that were not adjusted in the previous year audit; issues raised by external quality control reviewers; problems with the industry regulator; or whether the proposed partner and manager face any disciplinary investigations or litigation, or have been involved in any advocacy issues relating to accounting or other issues of relevance to this client.

Finally, this guidance is silent about auditors' independence and public responsibility being key features of audit quality. Despite being issued subsequent to auditor independence reforms and public scrutiny of auditor–client relationships, the audit firm's RFP guide

4. A review of national and provincial accounting guidance in Canada did not uncover detailed guidelines for engaging auditors through an RFP.

TABLE 1

Abridged audit firm guidance on the RFP for audit engagements

-
1. Define objectives.
 - Is the company seeking improved client service; access to a wider range of industry/technical expertise; better continuity a test of the market; new ideas/approach to their audit; or a fee reduction?
 - Specify a scope of services. Are all subsidiaries and locations included? Is this proposal only for audit services, or also for tax and other services? What is the time period of the appointment?
 2. Plan the process.
 - Establish a project manager to manage the process efficiently (e.g., a member of management who is the direct contact for all information/inquiries). No contact should be made with anyone at the company, except the project manager.
 - Specify what information the organization will make available to audit firms bidding for this engagement: mission statement, corporate strategy, and organization structure, recent financial statements, budgets, year-end consolidation process, internal audit scope and structure of internal audit department, key IT systems, and current tax status.
 - Set timetable, giving enough time so a new appointment can be made at the annual meeting.
 - Specify the scope (page limit) of written proposals and format of oral presentations.
 - Identify who will make the decision. Recommended is a selection panel composed of some mix of management and audit committee members to make a recommendation to the audit committee (which will then recommend to the board).
 - Identify who will meet the bidders. Suggested are the CEO, CFO, all Audit Committee members, board chair, CIO, Controller, Treasurer and heads of Internal Audit, Tax and Risk Management (preferably all members of the selection panel).
 3. Set up evaluation criteria for ranking the bidders (using a 4-point score), such as:
 - Understand my industry and business and have the requisite national/global coverage needed.
 - Industry expertise: involvement in industry associations, market share in industry.
 - People: specific identification of team members from partner to junior auditors. Do you trust them? Is there enough depth of expertise?
 - Relationship: is there a personal fit between key audit partners and managers with members of your team? Do the CFO, Controller and finance team believe they will have a relationship with the auditor based on trust and respect for each other?
 - Commitment: How committed is the audit firm to providing you with the service you want? How far are they prepared to go? Level of partner autonomy can be an indicator of commitment.
 - Audit methodology and approach: Risk-based approach, discussion of key risk areas identified, technical issue resolution process, quality control process, proactive in bringing new ideas, dedicated industry expertise you can access, efficient in conducting the audit, quoting a realistic fee to do a proper audit.
 - Fees: multiple year fee quote and breakdown of hours by rank and hourly rate by rank.
 - Other considerations: previous experience with the audit firm, recommendations from others who have dealt with senior members of your proposed team, external regulators and financiers' opinions, independence and objectivity, and ability to cope with audit partner rotation requirements and staff continuity.
-

appears to emphasize business imperatives for the client and auditor to enter into an engagement (Humphrey 2008). The guide includes considerations about how the audit firm shows commitment to the company and how far it is willing to go to satisfy management. Furthermore, management (rather than the audit committee) is envisioned as the "client" of the audit firm. The guidelines are specified in a manner for procuring any generic professional service; there does not appear to be any unique aspect related to auditing, except for auditors' affirmation of being independent as "other considerations".

Taken together, these process recommendations suggest that management, rather than the audit committee, should be the central focus of courtship activities in the audit RFP process. If, at this early stage of auditor–client interaction, the auditor sees management as the client, then how credible will the contention be later that the audit committee is the client?

3. Research method

We began our data collection six months after the company's RFP process and appointment of a new external auditor.⁵ We became aware of the RFP immediately after the auditor appointment decision was made. Our initial step was to obtain a copy of the company's RFP document from the CFO. We obtained copies of the bid (proposal) documents directly from all Big 4 audit firms who bid for this audit. The firms are hereafter identified as: Auditor 1 (incumbent), Auditor 2 (winning bidder), Auditor 3, and Auditor 4.

We interviewed the CFO and the chair of the audit committee of the company. After obtaining clearance from the CFO, the managing partners of the four audit firms identified the proposed lead engagement partner and arranged interviews with the engagement partners. We interviewed each of the four proposed engagement audit partners who oversaw the development of the bid documents.⁶ Each interview took 60–90 minutes and followed one script for the company and another script for the auditors (Interview Script online).⁷ We developed the scripts primarily based on information items requested in the company's RFP document, as well as the researchers' experience and review of auditing literature. We recorded the interviews on audiotape and took handwritten notes. The interviewees were provided with a copy of the script prior to the interview. In our semi-structured interviews, we used the script as a guideline, allowing the interviewees and ourselves to pursue interesting avenues as they arose (Hirst and Koonce 1996). The interviews were transcribed by an independent research assistant. The duration of our data gathering process was approximately six months.

We conducted follow-up interviews with the company to clarify our initial observations and we obtained additional records of the RFP process. These documents include: minutes of the board and audit committee meetings regarding auditor selection; an outline of the client's prescribed RFP process; written correspondence between the audit committee and management; completed evaluation forms assessing the bids; and management's completed scorecard summarizing deliberations from all selection committee members about each firm. We also reviewed publicly available records, including the company's website and annual report. Although much of the information exchange and interaction among the audit committee, management and the auditors is conducted verbally, these records fill in the rich details of the company's RFP process. The documentation aids us to better understand the interviewees' accounts of their own and others' judgments, decisions and observations made in the past. All research participants were aware of our access to extensive private records. One of the authors prepared a table to summarize the interview transcripts and RFP documents and to categorize the information produced in the RFP process into broad themes and auditor selection criteria. Two other co-authors, both chartered accountants, independently read and coded all materials in the summary table. Coding differences were discussed and resolved by the coders. Guided by key RFP decision points identified in the table, the authors prepared a summary report and pro-

5. We then negotiated access and secured consent with the company and each of the Big 4 audit firms who participated in the RFP. We received authorization for documents from the company and the local office managing partner of each office.

6. In 2 of 4 sessions, the office managing partner also participated.

7. Please see supporting information, "Interview Script," as an addition to the online article.

vided it to respondents for comment and clarification. The CFO and audit committee chair each scheduled individual meetings to discuss the report, and the CFO suggested several wording changes. None of the audit partners sought any changes.

4. Description of primary research site

Features of the company and its governance

The company is a large (>\$10 billion in assets) organization based in Canada. It has complex regional operations in an industry subject to federal regulation. The company is listed on the Toronto Stock Exchange (TSX) and has four subsidiaries. In the time leading up to the research study, the company had a long track record of consistent growth in sales and profit, with a conservative balance sheet. Company management is well regarded in the business community for its leadership in corporate governance. The CFO is a chartered accountant who had served in this executive role for over five years preceding the audit RFP. The company has an internal audit function.

The 12-person board of directors includes the company CEO and 11 other independent members.⁸ The five audit committee members all possess significant experience and exposure to accounting and financial reporting issues. Two members are chartered accountants. The audit committee is entirely composed of independent directors. Audit committee members are paid a 100 percent fee premium relative to the members of the other board committees. The audit committee chair had served as a director for over twenty years at the time of the RFP issuance and is a significant shareholder of the company. The chair is a senior business executive with industry experience but does not hold a professional accounting designation. The chair is also paid a 100 percent premium compared to all other board committee chair retainer fees. Furthermore, even though members are located in different cities across Canada, the audit committee meets more frequently than all other committees in the company and had a 100 percent attendance rate for all meetings during 2008. These audit committee characteristics (financial expertise, independence, fee levels, and meeting frequency) are consistent with those of the best audit committees in the United States (Engel, Hayes, and Wang 2010). The audit committee's mandate in the 2008 annual report states that it shall "recommend to the Board the appointment of the external auditors and review the terms of the external auditors' engagement".

The incumbent auditor, a Big 4 firm, had served this client through four different engagement partners because the client was established over 20 years ago. The other Big 4 firms had provided the company a range of other professional services (e.g., tax, valuation, IFRS, and software conversion). These three nonincumbent auditors may have been required to discontinue some of these services if they were to win the audit engagement.

The request-for-proposal process

The company issued the RFP to engage an external auditor beginning fiscal year 2008. Management and the audit committee agreed that the size, complexity and strategic direction of the growing company demanded deeper industry expertise than the incumbent had been providing with its current audit team. The CFO stated: "We needed more knowledge of [industry], in particular at a high level... and you can't get that in [local city] unless they bring it in." The audit committee chair echoed this need: "The depth of [the local] auditing pool was really being challenged."

Both the CFO and the audit committee chair also commented that accelerated mandatory audit partner rotation gave rise to audit service challenges that, beyond the incum-

8. The CEO and board chair positions are split such that separate individuals hold each position.

bent firm's difficulties in providing expert resources, weakened its fit with the company. The company's decision to issue an RFP was motivated, in part, by dissatisfaction with the incumbent audit partner. The CFO, audit committee chair and incumbent auditor all indicated that this dissatisfaction was attributable to incongruence of working styles and processes between management and the audit partner who had been assigned in mandatory partner rotation protocols; management disliked the "bedside manner" of this audit partner.⁹ The CFO described the impact of partner rotation on the company: "Because there is a change in auditor or partner every five years... the fit changes, and then as well because of the auditor rotation there is a lot more [industry] auditor partners out in Canada that no longer have [industry] clients because they had to rotate off." The audit committee chair also described the appeal of investigating alternative external auditors: "We realized that the rotation challenges that we were seeing were creating opportunities in other auditing firms as experienced lead auditors on various [industry] relationships were becoming available."

For the company, inviting tenders for services is not an automatic activity. The CFO identified two other (nonaudit) RFP processes in the company's recent history. When the company requires professional services, it tends to consider a single provider and chooses the firm on a case-by-case basis. The previous RFP for audit services led to the reappointment of the incumbent Auditor 1. At the time of the current RFP, the audit committee chair had never before served on any audit committee where the company changed auditors.

Once the company decided to issue its audit RFP, it formed a selection committee of eleven members. The committee included all five audit committee members, as well as the CEO, CFO, head internal auditor, senior VP–operations, general counsel, and VP–finance. Five committee members have professional accounting designations. Panel A in Table 2 summarizes characteristics of the selection committee.

The CFO drafted the RFP with reference to a practitioner guide and template published by Auditor 2 (the auditor that ultimately won the engagement). An anonymized version of the RFP is included (X Company Request for Proposal online).¹⁰ The RFP describes the scope of the engagement, lists auditor selection committee members, and outlines the communication process, including response deadlines and page limits. The engagement entailed annual audits, quarterly reviews, and reviews or specified procedures at subsidiaries. Though not included in the engagement scope, auditors were invited to provide information on their tax and advisory services. The RFP describes the official roles of the selection committee, the audit committee and the board: "The selection committee will make recommendations to the audit committee and the audit committee will select the external auditor for recommendation to the board and shareholders."

Respondents were asked to address specific items listed in the RFP. In order to develop their proposals, prospective auditors could access internal documents in a "data room" for 28 days, consult with executives over a two-day period, and meet the audit committee chair (but not the other members) for 30 minutes by appointment. The VP–finance was the single point of contact for auditor inquiries and site visits. Respondents were explicitly prohibited from any direct contact with any other officer or director of the company under the threat of disqualification.

The audit committee approved the RFP, and the CFO subsequently sent the RFP to local offices of the Big 4 audit firms. No other firms were considered as prospective exter-

9. No interviewees mentioned that any accounting disagreements were a source of dissatisfaction with the incumbent auditor. As such, we did not feel we had any openings to dispute or challenge the representations being made to us about such a sensitive topic.

10. Please see supporting information, "X Company Request for Proposal," as an addition to the online article.

TABLE 2
Individuals involved in the RFP process

Panel A: Selection committee members

Position	Years of service in company/on board	Accounting and financial reporting experience
<i>Audit Committee Chair^a</i>	> 20	<ul style="list-style-type: none"> • Senior business executive
<i>Audit Committee Member</i>	> 15	<ul style="list-style-type: none"> • Professional accountant designation • Senior business executive
<i>Audit Committee Member</i>	> 10	<ul style="list-style-type: none"> • Professional accountant designation • Senior business executive
<i>Audit Committee Member</i>	> 5	<ul style="list-style-type: none"> • Senior business executive
<i>Audit Committee Member</i>	> 5	<ul style="list-style-type: none"> • Senior business executive
<i>President and CEO</i>	> 15	<ul style="list-style-type: none"> • Senior business executive
<i>CFO^a</i>	> 20	<ul style="list-style-type: none"> • Professional accountant designation • Senior business executive
<i>Chief Internal Auditor</i>	> 10	<ul style="list-style-type: none"> • Professional accountant designation • Senior business executive
<i>VP – Operations</i>	> 15	<ul style="list-style-type: none"> • Senior business executive
<i>General Counsel</i>	< 5	<ul style="list-style-type: none"> • Senior business executive
<i>VP – Finance</i>	> 5	<ul style="list-style-type: none"> • Professional accountant designation • Senior business executive

Panel B: Proposed engagement partners

Identification	Years of industry experience	Expertise	Engagement partner's home office	Firm's industry leadership ^b	Firm's relationship prior to RFP
<i>Auditor 1^{a, c}</i> (Incumbent)	> 25	<ul style="list-style-type: none"> • National industry leader • Relationship with regulator 	National	City	Audit services
<i>Auditor 2^{a, d}</i> (Winning bidder)	> 15	<ul style="list-style-type: none"> • Regional industry leader 	Regional (senior manager would relocate)	Regional	Nonaudit services
<i>Auditor 3^{a, c}</i>	> 20	<ul style="list-style-type: none"> • National industry leader • Relationship with regulator 	Regional	National	Nonaudit services
<i>Auditor 4^a</i>	> 20	<ul style="list-style-type: none"> • Relationship with regulator 	National (engagement partner would relocate)	Global	Nonaudit services

Notes:

^a Interview respondent.

^b As emphasized in the firm's written proposal. All firms demonstrated industry specialization in each market.

^c Interview conducted with managing partner of the local office. The managing partner was not assigned to the company's audit in the current or proposed engagements.

TABLE 2 (Continued)

^d Engagement partner was accompanied by the managing partner of the local office, who provided some responses during interview. The managing partner was proposed to serve as the local client relationship partner for the prospective engagement.

nal auditors. Panel B of Table 2 summarizes characteristics of the audit firms and the proposed engagement partners.

The timeline in Table 3 summarizes the RFP process and lists the corresponding documents produced at each stage. After 50 days of information acquisition and preparation, all four auditors submitted written proposals. These documents were evaluated and summarized by the CFO and VP-finance. The CFO then provided copies of the written proposals, the summary evaluation, and assessment forms (evaluations, rankings, and pros/cons tables) to the selection committee. These decision aids were developed by the CFO based on the Big 4 firm RFP guide, with a three-point score on eight attributes aligned with the RFP: knowledge of business, people, relationship, organizational fit, commitment, audit methodology, other services, and fees.

Thirty days later, all members of the selection committee spent one day attending the auditors' 60-minute oral presentations. The selection committee held a 30-minute discussion following each auditor presentation. Subsequent deliberations and the selection decision occurred rapidly, within the six days following the presentations. Selection committee members completed the assessment forms and provided additional qualitative comments on each auditor to the CFO. When the audit committee chair sent comments to the CFO, he/she also requested the CFO's recommendation of auditor. Subsequently, the CFO, in collaboration with the VP-finance, compiled the evaluation forms and produced a scorecard for each firm containing detailed criteria and justification for every score. The six management members of the selection committee held a meeting to select the top two candidates. The audit committee chair sat in on the first portion of this meeting. Afterward, the CFO and VP-finance summarized the pros and cons of the two finalist firms to arrive at a recommendation. The following day, the audit committee accepted the recommendation and brought it forward to the board. The board accepted the recommendation presented by the audit committee to appoint the new auditor on the same day. The incumbent auditor resigned from the engagement and the new auditor was appointed the next day.

5. Analysis

Role of the audit committee: Monitor the process

Our examination of the auditor engagement process reveals that management influence dominates many aspects of hiring the auditor. The decision to put the audit to tender was initiated by management's dissatisfaction with the incumbent auditor. The CFO, with the approval of the audit committee, drafted and sent the RFP to auditors. This practice departs from the American Institute of Certified Professional Accountants (AICPA) (2004) best practice recommendation that audit committee issue the RFP and jointly sign it with management. Throughout the information gathering process, the VP-finance was the single point of contact for prospective auditors. Establishing one person to coordinate all communication was one best practice recommended in the Big 4 firm's practitioner guide (Audit Firm 2007). However, this approach also allocated management control over the flow of information to both the audit committee and the auditors. The RFP explicitly limited the prospective auditors' contact with audit committee members other than the chair. Furthermore, it threatened to disqualify auditors if they attempted communication

TABLE 3
Timeline of RFP process

Event	Timeline (days)	Description of records produced	Made available to researchers (indicated by *)
1. Client sends RFP request letters to firms	0	RFP document	*
2. Firms return RFP acceptance and confidentiality agreement	7	Agreements from 4 firms	
3. Client distributes supplemental information package	7	<ul style="list-style-type: none"> • Organizational information • Financial reports and shareholder communications • Data room details and arrangements 	
4. Data room availability	7–35	<ul style="list-style-type: none"> • Strategic and business plans • Policy manuals • Internal control reports — IT, Internal Audit, flowcharts • Board meeting minutes <p>See Appendix S2 (online supporting information) for complete list</p>	
5. Prospective firm and client interviews	35, 36	n/a	
6. Receipt of submissions	51	Audit firm proposal (bid) documents	*
7. Management reads, summarizes and evaluates written proposals		Table listing pros and cons of each proposal	*
8. Management provides summary and written proposals to Selection Committee members		Written summary of proposals	*
9. Presentation to Selection Committee	81	n/a	
10. Audit Committee Chair ^a submits evaluation of auditor proposals and presentations to CFO	83	Completed evaluation form and rankings	*

(The table is continued on the next page.)

TABLE 3 (Continued)

Event	Timeline (days)	Description of records produced	Made available to researchers (indicated by *)
11. Management ^b meets to formulate recommendation of auditor	85	<ul style="list-style-type: none"> • Completed evaluation form and rankings • Scorecard rating each firm on various attributes, with rationale for each score compiled from individual scorecards • Pros and cons comparison of two “finalist” firms 	<p>*</p> <p>*</p> <p>*</p>
12. Audit Committee meets to formulate auditor recommendation	86	Meeting minutes	*
13. Audit Committee recommends auditor change to board; board approves selection	86	Meeting minutes	*
14. Communication of decision to winning audit firm	88	Notification to winning firm	
15. Debrief for losing firms	98–102	n/a	

^a Developed in consultation with another audit committee member.

^b Management includes: CEO, CFO, Internal Audit, Chief Counsel, VP Finance and Operations Manager (all executives are members of the Selection Committee). The AC Chair attended the first portion of meeting.

with individuals who were not specified, even if those sources could potentially have offered useful knowledge (e.g., internal auditors).

Hence, it appears that management exercised significant influence over the selection decision. The audit committee monitored the process but did not substantially control the information-gathering and decision-making activities. No meetings of the audit committee as a whole, with or without the prospective auditors, were held without the presence of company executives during deliberations.¹¹ Management specified the evaluation criteria and provided these to all selection committee members; later, management summarized the evaluations, met without the presence of the audit committee, and provided their recommendation to the audit committee. These practices fall short of corporate governance best practices that recommend the board to deliberate at in camera meetings (Joint Committee on Corporate Governance 2001).

The audit committee, however, was neither absent from the RFP process nor silent in the auditor selection decision. The audit committee chair met with each auditor and offered detailed input on the auditors to the CFO. All audit committee members attended

11. In a follow-up interview, the CFO clarified that such a meeting would have taken place if the audit committee was dissatisfied by the selection process or disagreed with management's recommendation of auditor.

auditor presentations. The chair indicated that the committee obtained another audit committee's template of questions for prospective auditors, in order to generate questions about "how they would work, and how they worked internally, and how they would communicate with [the company]; who makes decisions, how they reached decisions on difficult issues." Each audit committee member also submitted scorecards evaluating the auditors. In our follow-up conversations, management recognized the value of the audit committee's input about the national practices of each firm.

The auditors also commented on the audit committee's involvement during the RFP process. Auditor 4 indicated: "The nice thing about this one was being able to talk to the audit committee chair in the preliminary fact gathering stage — one doesn't always get that." Auditor 2's recollection of boardroom meetings with senior individuals, including the audit committee chair was "phenomenal." Overall, the auditors appeared satisfied with their level of engagement with the audit committee in the RFP and their comments suggest that they typically have very limited access to audit committee members. Given that regulatory reforms position audit committees as the client and empower them to be responsible for the auditor appointment process, it is a concern to observe the limited auditor-audit committee contact in this case and to learn that auditors seldom have access to the audit committee chair and/or members during the RFP process.

Corporate governance regulations assign formal authority over auditor selection to the audit committee. In this company, the audit committee requested and accepted management's recommendation. When formally and publicly nominating the auditor at the board meeting, the audit committee communicated its support for management's choice. It appears that the audit committee essentially left the decision to management, albeit they had some input and presence throughout the process.

As an alternative approach, the committee could have deliberated over the summary scorecard of all four firms or the comparison of two finalist firms to arrive at its own independent rankings. Auditor 1 described the ideal process: "If the audit committee wants to make the decision, then the audit committee says to management, 'We want you to give us your pros and cons on each of the bidders and leave it with us'." Even with such an approach, the audit committee might have found it difficult to challenge management's auditor preference. We present evidence that supports the conjecture of an auditor interviewed by Gendron and Bédard 2006 (227): management drives the selection process by giving the audit committee a recommendation along with all rationale that supports the desired auditor. An audit committee member in the same study surmises that the audit committee would not have the *de facto*, rather than *de jure*, power to reverse management's decision about engaging an auditor. Our observations also support auditor perceptions that management is the dominant force in auditor hiring and firing decisions: one partner interviewed by Cohen et al. 2010 states that the audit committee and auditor identify the audit committee's responsibility on paper, but acknowledge management's influence in practice.

In a follow-up interview with the audit committee chair, he/she reflected: "Our audit committee saw its primary role as one to ensure that a robust selection process was followed by the company, where the audit committee had substantive oversight, and had the final decision. We didn't see this role as requiring, or necessarily being compatible with, the audit committee actually conducting all work." The audit committee chair's comments suggest that the committee viewed its auditor appointment responsibility as a monitor, rather than a decision maker, and it carried out its duties based on this interpretation of its mandate. It seems the audit committee felt that management sought their approval throughout the RFP process. The audit committee also appeared satisfied that management never deviated from the agreed-upon process for auditor selection, which was based on the audit firm's RFP guidelines. We would not characterize the audit committee's behavior as

owning the decision in the way that practitioner guidance encourages (American Institute of Certified Professional Accountants (AICPA), 2004) or that regulators appear to intend. In our case, despite an ostensibly high-quality audit committee and a detailed RFP procedure, its role in auditor appointment was not to control the appointment decision, but to provide limited oversight and input on a process being conducted by management.

Role of the auditor: Identify the key decision maker

In our study of the RFP process to engage an external auditor, we examine the initial courtship phase of the auditor–client relationship, which precedes even the auditors’ client acceptance activities. This RFP process provides an opportunity to understand incumbent and prospective auditors’ perspectives on the company’s approach to auditor selection, and allows us to observe auditor behavior in response to management’s and the audit committee’s roles. All four auditors had been aware that the RFP would be issued prior to the company’s official invitation to bid. The auditors had multiple relationship channels through which they had interacted with the company on a professional and social level: the provision of professional services; active business development efforts directed by local and national offices; participation in accounting and industry seminars; and interpersonal contact in the local community. Thus, even prior to deciding to put the audit to tender, management and the audit committee had familiarity with key personalities at prospective audit firms. While partner or firm rotation can break relationships with a single audit partner, it is unlikely to completely sever links with audit firms. All Big 4 firms had working relationships with this company both before and after the audit selection decision was made.

We asked each auditor to specify the important items they wish to see when they respond to an RFP. All auditors mentioned the following items: the reason behind the company’s RFP issuance; evaluative criteria; background information on the company; clear details on the process; access to key people at the company; and a reasonable timeline.¹² One common concern among auditors is the possibility that a company issues an RFP with the primary objective of lowering audit fees through competition. Auditor 1 observed the rationale at some companies as: “Every time I am on a board, and when the board puts an audit out to tender, we either get a reduction in the price or we get more freebies thrown in.” Auditor 4 echoed that “just to be put through the motions to cut fees for the incumbent with no intention of changing firms is a waste of time for everybody.” All auditors agreed that the current RFP was well executed by the company with respect to information availability and clearly specified expectations beyond lowering audit fees.

The incumbent, Auditor 1, had a long-term relationship with the company. Auditor 1 believed the selection decision had already been made and perceived the RFP issuance to be motivated by management’s desire to switch audit firms. Auditor 1 describes his/her instinct on RFPs: “There is probably half of them that’s trying to confirm a decision, and I would say there is probably half of them that’s genuinely open-ended.” It appears that, during the proposal process, the incumbent auditor too heavily weighted its long-term, local relationship with the board and audit committee rather than management. For example, in its written proposal, Auditor 1 repeatedly emphasized transition costs of switching auditors. This was a key concern of the audit committee, but management had resolved that they were comfortable with the costs and effort of switching. Auditor 1 also emphasized its working relationship with the company’s internal audit department, which was another valuable aspect to the audit committee but not to management. These two

12. These items are not listed in order of priority to the respondents. Although we had requested that they list and prioritize each item, interviewees indicated that they considered most items equally important.

aspects of audit services were differentiating qualities that could only be raised by the incumbent. However, management was dissatisfied with the working style and fit with the incumbent engagement partner, and placed more importance on auditors' demonstrations of commitment and cultural fit.¹³

Based on our observation that the company provided extensive access to their records to ensure that auditors had enough background knowledge on the company, we had expected that the prospective auditors would be highly interested in the risk-related documentation made available to them.¹⁴ As the audit committee chair articulated: "We were very concerned about making sure that they believed they knew enough of the company's results, and the company's transactions, to ensure that they did not view the risk of restatement as being even a low probability. We wanted to clear that outright from the start." During interviews, the auditors agreed on the importance of gathering enough knowledge to avoid future restatements. The academic literature reports that auditors integrate risk information into engagement pricing and client acceptance decisions (Bell, Landsman, and Shackelford 2001; Johnstone 2000; Johnstone and Bedard 2003). However, our auditor interviews suggest a quite different approach to information acquisition.

Prior to presenting their proposals, the auditors did not scrutinize the incumbent auditor's management letter to the company — a primary means for outsiders to identify internal control weaknesses. Furthermore, auditors did not investigate the details of accounting adjustments and reporting issues raised by the incumbent auditor, nor whether these items were booked or carried forward to future periods. Although these records of the prior two years' audits were available to them in the data room, Auditors 2 and 4 said that they had not read the management letters. Interviews revealed that many clients do not provide such information during an RFP process.

The three nonincumbent auditors appeared reluctant to probe management or the audit committee for further documentation beyond what was already in the data room. For example, auditors did not ask to see correspondence with the federal regulator on accounting issues, internal reports to the board and audit committee, breakdowns of how the incumbent auditor allocated staff time, or a schedule of unadjusted errors negotiated with the incumbent auditor. They also appeared not to have scrutinized documents on the company's internal audit system. Auditors only asked questions indirectly and verbally about these matters.

Some aspects of auditors' choice not to probe for what we thought was critical information may be attributable to their prior due diligence from other information sources, their overall assessment of the client as being low-risk in a highly regulated industry, and their intense desire to win this high-profile engagement. Yet they could not definitively have known potentially useful information, such as the unadjusted errors, through their own independent investigations. When we questioned auditors about their lack of attention to risk-related information, we learned that such risk assessments are typically undertaken through client acceptance procedures after acquiring the engagement. Auditor 1, the incumbent, described how bidding auditors might view the company: "[It] would be such a big frog in a small pond for any of the audit firms that I can understand why they probably all had the attitude of we don't care how ugly it is, we want the brand and we want the business." It appears that, for this RFP, all audit firms had already made the decision to attempt to acquire the client before the start of the RFP process.

In the time preceding and during the RFP process, one might describe the auditor's behavior toward the client as a courtship. During this courtship, as parties got to know

13. We elaborate on the company's evaluation criteria in the next subsection.

14. Refer to Appendix S2 (online supporting information) for the complete list of documents provided in the data room and listed in Part C of the RFP.

each other better and convey their needs before entering the engagement, auditors sought information that helped them establish familiarity with the client's needs, rather than evaluate client risk. Auditor 4 describes the RFP information exchange process: "You want to try and confirm who the key decision makers are... so that you can find out as much about them and what is important to them and appeal to that in your document and in your orals." The information acquisition strategy of the nonincumbent auditors enabled them to identify management (rather than the audit committee) as the client, ascertain management's influence over the auditor selection decision, and determine management's preferences implicit in the RFP process. This knowledge helped auditors tailor the information in their written proposals and oral presentations to the needs and desires of management.

Our interviews revealed that management sought preferred client treatment (the CFO described this status as being considered a "star client"—which could also be interpreted as a too-big-to-lose client). Management did not express this expectation explicitly to auditors in RFP documentation, but through cues given in meetings and interviews. For example, the CFO discussed the incumbent auditor's oral presentation as follows: "To me, Auditor 1 was more about: we are really good at what we do, you've had us for a long time, and why would you switch. But you never got the feeling that we would be one of their star clients; it never came across that we were really important to them." The auditors that stood apart from their competitors were those who were able to identify and persuasively convey a commitment to meeting these needs. By courting the client in this manner, the auditors signaled responsiveness and good fit with client management. A potential consequence of mandatory audit firm rotation is that management could have more frequent opportunities to demand preferred client treatment, and auditors may repeatedly demonstrate commitment and alignment when courting clients that seek a new auditor.

Role of management: Seek the best fit

Audit firms' inability to differentiate themselves from competitors through expertise

The CFO and audit committee chair both cited the company's need for deeper auditor industry expertise as the primary reason for the RFP issuance. Both were concerned about the company's growth, complexity and strategic direction, and they worried that the incumbent auditor was approaching its limits in the depths of expert resources with respect to engagement partners that could be assigned to the client. The CFO was willing to "look everywhere and not be at all concerned with where the location of the partner was." However, our review of auditors' proposals revealed little industry expertise differentiation, even though auditors attempted to tailor their expertise to company-specific issues. The company also considered the auditors' identified risks and interpretations of critical accounting policies. The audit committee chair was not seeking auditor agreement on any specific accounting positions, and the CFO clearly stated "we weren't shopping for a different opinion on accounting".

All proposals presented: industry leadership in global, national, regional and local markets¹⁵; partners with deep industry specialization and regulatory involvement from regional and national offices; industry expertise in other services, including tax and information systems; an extensive set of thought-leadership resources (e.g., forums, websites, roundtables, e-mail alerts and industry-specific publications); and references from industry-specific clients. The auditors attempted to signal expertise through face-to-face interactions: "You look for opportunities in those data-gathering meetings to convey expertise.

15. Each auditor demonstrated industry specialization at every market level, but their proposals emphasized market leadership in different locales, as illustrated in panel B of Table 1.

You obviously did in the written document, and then you seek to do that as well in the oral, both in the prepared remarks as well as you do with the Q&A portion” (Auditor 3).

On being asked about perceiving differences among the auditors’ expertise, the CFO said: “No, we didn’t. We all unanimously felt that every firm could do the job very well with the team they had presented.” When asked about the importance of oral presentations, the CFO indicated he/she did not ask technical questions during those sessions. Evaluation scorecards from the selection committee indicate that the scores of all auditors clustered near the top of the rating scale for the “understanding our business and our industry” category. Technical skills and resources may help set the Big 4 firms apart from the smaller ones, but not from one another. Even though industry expertise was an important factor in issuing the RFP and an explicit criterion for auditor selection, the auditors’ inability to differentiate themselves based on technical expertise required the client to make distinctions based on other intangible dimensions that potentially hinder auditor objectivity, such as relationship and fit.

Importance of relationships, organizational fit and commitment

The company’s concerns about organizational fit with the incumbent engagement partner contributed to the search for a new auditor. In the company’s evaluation scorecard, the selection committee was directed to consider the audit team’s rapport, chemistry, and past experience with the company under the “relationship” dimension. During interviews, the CFO frequently referred to this criterion as “cultural fit”. In articulating the traits most sought in an engagement partner, the CFO offered the following insights: “The most important thing for me is to be able to call the individual up and talk the same language. Be able to discuss all the issues in the industry, how the accounting impacts... what’s going on in terms of regulation.... You have to be able to debate the issues in order to come to the best answer.” The CFO acquired pertinent information from the auditors’ oral presentations through strategic questioning: “They would be questions where I would look for how the answer was given... more qualitative questions than expertise questions.”

The audit committee chair had broader views on desirable partner traits: “We want someone that is communicative, involved, has got experience, someone who is open [and] practical.” The chair placed greater weight on references than on presentations, because “the party that is selling is trying to show his best side or his interpretation of it” and “the main thing for us was the reputation within the industry of not only the company, but the individuals.” Thus, the audit committee chair sought evidence of the auditor’s reputation with other clients: “It’s not so much what somebody says, it’s actually what happens in practice, and what’s happened elsewhere is a pretty good indicator, I think, of how that might work for us.”

However, rather than including referees from both management and audit committees of current clients, auditors overwhelmingly chose “C-suite” executives (in this case, CEOs, CFOs, and controllers) as referees, with approximately 75 percent being CFOs and only one being an audit committee chair. This behavior was another indication that the auditors perceived the CFO, rather than the audit committee, as the key decision maker. Management contacted all client references, and even reached out through informal channels to other industry colleagues who were not included in the list. Auditors’ reliance on favorable references from management at current clients to engage future clients raises concerns about auditor independence, and potentially weakens the power of the auditor vis-à-vis management.

Existing social and professional relationships played heavily into how audit firms were evaluated. Consistent with prior research on the value of relationships with accounting firm alumni (Lennox and Park 2007), the winning proposal (Auditor 2) came from the CFO’s former employer. Furthermore, the CFO noted that the tax partner at Auditor 2

had drawn on past experience as the client's tax services provider to make a very strong impression during the oral presentations, and the tax element of Auditor 2's proposal was "at the end of the day, one of the things that swung the vote."¹⁶ Cognizant that the firm's relationship with the client was at risk, the incumbent Auditor 1 proposed a switch to a new engagement partner who might better fit.¹⁷ Auditor 1 confirmed that the profession sees theirs as a relationship business: "What it comes down to is that formal rules are formal rules, and structures are structures, but people do business with people." Accordingly, management focused on relationships with individuals, rather than on independence of the audit firm.

Management viewed the relationship with the audit firm as a connection beyond the audit engagement, and the CFO highly regarded auditors who had ties to industry associations and regulators. The CFO saw the auditor as an access point to new business customers, competitors, and potential collaborators. When asked about the value of the external auditor assigning a "relationship partner", the CFO responded: "What you are looking for there is more business exposure, I guess. Like a conduit, you can call up and see if they have clients that need [our product]." The advantages of the auditor's potential as a connecting link to opportunities with industry peers appeared to dominate any concerns the company might have about conflict of interest and leakage of proprietary information. In this sense, management views the engagement as more than an audit — it is a relationship that brings new business opportunities.

Expectations about organizational fit and commitment to the client were not articulated in the RFP, but the CFO, the audit committee, and all auditors recognized the competitive importance of these elements. Auditors' written proposals revealed a tendency to mirror the company by adopting its slogans in an attempt to show a fit between their organizations with respect to culture, thinking, and attitudes (Gremier and Gwinner 2008). Auditors 3 and 4 both paraphrased the client's slogans in either the header or footer of every second page. Auditor 2 paraphrased the client's slogan in the executive summary and in three section headings throughout the proposal. The incumbent Auditor 1 took a different approach to mirroring the company by highlighting a business role model award for which both organizations had received top honors. By injecting client slogans and mantras into their own narrative, all auditors attempted to convince the clients about cultural alignment.

The CFO and the audit committee chair both felt it was important to be treated as a priority client, and they considered each firm's national portfolio of clients to ascertain the company's status. As gestures of priority treatment, all nonincumbent auditors were accompanied by their firm's national CEO at their oral presentations. The CFO's reaction was: "Three of the firms brought their CEOs, which made a difference to the one firm that didn't. It was quite noticeable, so you didn't get the feeling that you were considered as important as you wanted to be in terms of... if you need something, are you going to get it?" Two auditors also demonstrated commitment by offering to relocate industry specialists to the company's city. Auditor 3 proposed to move a partner and Auditor 2 proposed to move a senior manager in their attempts to stand out from the competitors.

Offering audit partner autonomy to convey responsiveness

Auditors articulated their national office consultation protocols with respect to complex accounting issues in order to demonstrate their commitment to the prospective client. The

16. The RFP and the proposals address independence concerns associated with the provision of nonaudit services.

17. The practice of matching the engagement partner to the CFO provides further evidence to support McCracken, Salterio, and Gibbins's 2008 argument that the CFO determines partner assignments.

RFP asked auditors to address this issue, and both the CFO and the audit committee chair considered local partner autonomy from the national office to be a signal of organizational fit. In particular, the CFO wanted to know “who made the decision on complex accounting issues.... It’s very frustrating when you don’t know who is making the decision and you are trying to get an answer, and then you get this flow through thing happening, filtering. And that just wasn’t comfortable to us, or our preference was not to have that.” The audit committee chair also articulated: “I think the engagement partner should be making the decision. Now, obviously, he is not capable of knowing everything, so undoubtedly national policy is all going to come through, but he should be the one that not only ends up making the decision but is involved with the communication of that to the client.”

The auditors recognized the importance of showing responsiveness during the RFP process to convince the client that they could expect similar behavior during the audit engagement. Two audit firms sought to address this issue of local partner autonomy in their bids by emphasizing the seniority of their proposed audit partners and providing a description of their process to identify, discuss, and communicate such issues without promising local control. The other two audit firms responded in written proposals by promising that the final and binding decision on complex accounting matters would be made by the engagement partner. Of these latter two, one written proposal assured the client that the final decision would be made locally.¹⁸

The proposed engagement partner of the audit firm that promised partner autonomy perceived this as a communication issue, not a substantive one. The engagement partner would be subject to the audit firm’s normal consultation and quality control processes, and the proposal was simply promising that the engagement partner would be a single point of contact for all accounting-related discussions. The other auditor indicated that the partner did, in fact, have autonomy and could decide if and when he/she needed to consult the head office. These auditors did not perceive the inability to use national headquarters as a bargaining tactic in future sessions with the client (e.g., “I sympathize with your position, but national office says, ‘No’”) as an important concession.¹⁹ As a practical matter, the client cannot know whether the local partner or the head office makes the decision; he/she can only identify the person who negotiates with him/her on a contentious item and communicates the firm’s position. In this sense, it appears to be only a communication decision. However, the auditing literature indicates that having a head office technical partner involved in a negotiation offers leverage to the audit firm (Gibbins, Salterio, and Webb 2001). Likewise, social psychology research suggests that team negotiation is more effective than individual negotiation in accountability related contexts (O’Connor 1997). Making this process concession during the RFP limits the auditors’ future bargaining tactics and precludes the partner from using head office to defend an unfavorable decision to management. The auditor promises that we observe here call to mind a frequently cited reason for the collapse of Arthur Andersen: the transfer of authority for making the

18. In a speech at the Council of Institutional Investors 2011 Spring Meeting, James R. Doty, Chairman of the PCAOB, offers further troubling statements that auditors have pitched to win clients, revealed through his office’s inspections: “We will support the desired outcome where the audit team may be confronted with an issue that merits consultation with our National Office” and “Our audit decisions are made by the global engagement partner with no second guessing or National Office reversals.”

19. According to Toffler 2003, the headquarters unit serves several important functions, including (i) having a high level of expertise available to all audit engagements irrespective of their location; (ii) enforcing a uniform application of judgment across the firm; and (iii) protecting the engagement partners from undue pressure from client executives by allowing them a shelter behind the opinion of the headquarters experts when differences arise. Salterio and Denham (1997) also report that accounting consultation units are brought in when auditors encounter (i) accounting policies where there is a choice in the standard or no standard; (ii) measurement and valuation alternatives; and (iii) disclosure requirements.

final call on disputed technical issues from its expert unit headquartered in Chicago to the local engagement partners (Toffler 2003).

The CFO found it possible to perceive differences in the auditors' approach to complex accounting issues: "With [A] and [B] you sort of got the feeling... that the engagement partner wasn't at the top of the decision-making tree, that there were other people up there." The audit committee chair learned from references that two firms were "more unilateral in the way that the decisions are reached: edicts, as opposed to more centralized decisions, and a lack of communication relating to the rationale of those decisions." In our interviews and in the company's records of the deliberation, the terms "flexible" and "inflexible" were frequently invoked by both the CFO and the audit committee chair, with a preference for flexibility. It appears that the CFO and the audit committee chair regarded local partner autonomy, flexibility, and responsiveness as the best organizational fit. This preference for seeking auditors' alignment with the company is another example of conditions that shift the focus away from independence when selecting a new auditor.

Competitive pressures on auditors' fee quotes

Although all firms were required to communicate their two-year fee schedules in their RFP responses, the CFO indicated: "We were very clear to everybody that the fee was not the thing that would drive our decision in any event." The audit committee chair also insisted: "We did not go through an RFP process in order to reduce the fee and we've always felt that you should be prepared to pay a reasonable fee for the services that you are looking to obtain in whatever area you are trying to seek them."

Our investigation reveals considerable differences in audit fee schedules, supporting the observations of Beck and Barefield 1986 in a government procurement setting. While the nonincumbent auditors proposed absorption of transition costs, the incumbent Auditor 1 highlighted "significant hidden costs in auditor transition." The nonincumbents expected that the incumbent could not deviate much from the prior year's publicly disclosed fee. The incumbent fee serves as a benchmark and reflects a deep knowledge of the client and a thorough assessment of associated risks and the extent of audit work necessary for the engagement (Johnstone and Bedard 2001; Bedard and Johnstone 2004; Choi, Kim, Liu, and Simunic 2008). The nonincumbent auditors' bids for total engagement fees ranged from materially below (Auditors 2 and 4) to materially above the incumbent's fee (Auditor 4). Despite the client's insistence that fees would not be a key factor in auditor selection, the engagement went to Auditor 2, who had proposed the lowest fee.²⁰

The RFP required future billings for audit fees to identify each personnel by rank, hours worked, and hourly rate.²¹ Auditors' fee schedules allocated these hours by financial statement cycle (e.g., sales, receivables). Auditors explained in the interviews that estimating the total required hours was important in determining their fee. In contrast, we observed that the CFO paid more attention to total fees and the auditors' allocation of senior versus junior personnel rather than total hours.²² Although management and the audit committee chair had voiced a preference for greater involvement of senior auditors, Auditor 2 proposed greater staff hours and fewer partner/manager hours relative to the incumbent's current year time budget. In the interviews, both the audit committee chair

20. In its April 2011 report, the Canadian Public Accountability Board (CPAB) deplores client pressure on audit firms to reduce fees and indicates that it will specifically focus its inspections on engagements where the auditor won or continued an audit engagement at a discounted fee.

21. The CFO noted that hourly rates charged were lower for regional office partners versus national office partners.

22. "Because clients do not monitor the number of hours their auditors spend on the assignment, the hourly billing rate is not a meaningful measure of price. The total price of the audit assignment — the price of buying the audit certificate — is the relevant price variable" (Sunder 1997, 117–18).

and the CFO expressed concern that a low bid signaled the auditor might not have understood the amount of work involved. The CFO said: “For [Auditor 2], we were not sure on how they would do because the audit fee was too low.... I think they may have underestimated the work they needed to do on a couple of our subsidiaries.” The audit committee chair offered the following rationalization: “Even though it was lower, I don’t think any of us regarded it as... a fixed indication of how it would work in the future.”

Auditor 3 submitted bids for three different levels of audit service. In addition to the middle bid for marginally higher than the incumbent’s fee, the other two bids were priced at materially above and marginally below. The premium-priced service offered a more experienced partner and staff, more audit hours, and other “non-audit-related” items, such as more frequent meetings, “free” time to consult on issues, customer satisfaction discussions, and industry- and strategy-related discussions with experts from the head office. Various consulting services were therein built into the audit fee, blurring the distinction between auditing and consulting (Power 2003). The discounted option required extensive work commitment from the client’s internal audit department, and proposed fewer audit hours, a less experienced partner and staff, and less frequent meetings and advisory discussions. The auditor’s attempt to explicitly price the experience of team members appears to have backfired and undermined the credibility of the proposal. The CFO indicated that these fee options created confusion, and the selection committee was put off by Auditor 3’s pricing strategy. The audit committee chair agreed: “I think at the end result that was probably a mistake on their part.... I don’t care for that type of stuff.... I didn’t think the idea of having an audit firm where the service you get depends on how much you pay is really the impression that they would want to give.”

Auditors attempted to further differentiate themselves from competitors through their proposed fee schedules. Management and the audit committee perceived significant differences among auditors’ proposed fee schedules, and one distinctive attribute of the winning proposal was its low fee. This low fee was rationalized by Auditor 2 as alleviating the transition costs that had been concerning the audit committee. The low fee could be understood as indicating responsiveness to audit committee concerns about transition costs. Presumably, the other bidders had not picked up on this transition cost concern, or at least had not responded so visibly to address it. Auditor 3 appeared to be unsure about the fee/service mix that management would prefer, and thus proposed three different engagement bundles. Essentially, Auditor 3 conceded control over key elements of audit planning decisions (i.e., hours and staffing) to the client. Even with the client’s repeated assurances that it was not exerting fee pressure on the engagement, the competitive nature of the audit RFP process and the impetus to win ultimately resulted in a lower fee for the client.

6. Discussion and conclusion

We investigate an RFP event involving Big 4 audit firms, client management, and the audit committee at a large, publicly listed enterprise, which culminated in appointment of a new auditor. We find that management controlled access to documents and people, and it played a powerful role in making the auditor appointment decision. Following practitioner guidance on external auditor selection, management dominated the information exchange and made its selection after gathering information directly from prospective auditors and seeking out additional sources of information about intangible dimensions, such as the audit partner’s relationships with other clients.

The audit committee’s role involved oversight of management’s auditor selection process and approval of management’s recommendation. Despite an ostensibly high-quality audit committee that was concerned with ensuring compliance with the RFP process, we observed a departure from the criteria specified in the RFP: management engaged the

audit firm that offered the least senior level expertise and the lowest fee. Even though the audit committee was aware that the audit firm with the lowest bid may not have adequately scoped the audit, these concerns did not weigh significantly on the final decision. Also, instead of directly challenging the prospective auditors to demonstrate independence, the audit committee adopted management's priorities in encouraging prospective auditors to demonstrate responsiveness to management. The audit committee participated throughout the RFP process, but it did not control the auditor selection decision, it did not compel the auditors to perceive the audit committee as the client's key decision maker, and its role in selecting the auditor was largely ceremonial (Cohen et al. 2010). Our study sheds light on what underlies decision making in the imperative audit committee responsibility of auditor appointment: nuanced interactions and power asymmetry among management, the audit committee, and auditors.

We observed several contradictory statements and behaviors from both the CFO and audit committee chair, such as: preferring partner autonomy, but insisting that the RFP was not opinion shopping; selecting the lowest priced bid, but claiming that the price was not a primary criterion or motivation for the RFP; and engaging the auditor that proposed the lowest amount of senior personnel hours, but citing the company's demand for deeper industry expertise as the key purpose of the RFP. The audit committee chair did not seem to be cognizant of these discrepancies. Because the audit committee had interpreted its role as a monitor of the auditor selection process, he/she seemed not to have probed information that might have brought these contradictions to light, such as the auditors' assertions about local partner autonomy and the detailed chart produced by each audit firm of proposed hours for each rank of personnel. Because the audit committee had conferred to management control over the information flow and the ultimate selection decision, we did not observe a coherent explanation from the chair about these contradictions.

Prospective auditors were reticent to probe the client for information that would have helped them identify risks before accepting the engagement. Consistent with Power 2003 and Humphrey and Moizer 1990, we observe auditors pursuing client acquisition as a commercial activity, rather than a professional one. The auditors were focused on winning the client and were willing to cut fees, move partners to the client's head office city, and curtail quality control. The attitude of the auditors was to get the business now, and worry later about whatever issues might arise in the future. Our findings, coupled with previously reported evidence that new auditors are not only more vulnerable to fraud (Treadway 1987) but also to errors in early years (Johnson, Khurana, and Reynolds 2002), add to concerns about auditors' risk management practices (Beasley et al. 2009). Furthermore, all Big 4 auditors were unable to convey their technical expertise in a way that differentiated themselves from competitors. Recent comments from the chairman of PCAOB and the inspection reports of the Canadian Public Accountability Board (CPAB) articulate concerns about some of the behaviors that we document (e.g., client advocacy and fee reductions), and provide further examples of these problematic auditing practices occurring in both the United States and Canada.²³ These observations raise troubling questions about auditors' willingness to engage in such activity. The auditors' commercial priorities emphasize a strong relationship and familiarity between the auditor and management. Regulatory reforms to sever such ties appear not to fundamentally change the auditor–client (management) relationship.

23. The 2011 CPAB inspection report raises concerns that “predatory pricing by audit firms” occurs and “tendering of the audit frequently results in a fee reduction” (CPAB 2011, 9). Also see comments on client advocacy from PCAOB Chairman James Doty in footnote 16.

Having the external auditor appointed by an audit committee, mandating audit partner rotation, and proposing audit firm rotation are regulatory measures that are intended to preserve the independence of auditors from their clients. Even though a proposed audit firm rotation requirement is intended to introduce a fresh look (Tan 1995), large public companies are likely to simultaneously employ all Big 4 firms for a range of professional service needs. In our case study, all Big 4 audit firms provided services to the company both before and after the audit RFP process. Thus, for these types of organizations, the viability of severing existing relationships to bring in a truly independent auditor mindset through audit firm rotation is questionable.

Our study also points us to another counterargument against audit firm rotation. The very process of engaging a new auditor, combined with competition in the market for audit services, encourages actions that appear to enhance management power and weaken auditor independence. Audit firm rotation promotes perennial search and courtship of potential client management by auditors. Rotation affords client management the opportunity to avoid audit firms that they dislike without having to fire them, and obscures opinion shopping motives for auditor switching that might otherwise raise red flags to capital markets and regulators (Lu 2006). Auditor change also puts pressure on audit fees, and requires auditors to demonstrate commitment and responsiveness to the management of both prospective clients and current ones used as referees.

Auditors devoted considerable due diligence efforts to ascertaining the key decision maker in this RFP setting and were not surprised to find that it was the CFO. This practice of tailoring the audit proposal according to the CFO's preferences is an audit firm relationship management strategy that parallels the observations of McCracken et al. 2008, who report that audit firms assign engagement partners to match CFO profiles. The auditors' mindsets suggest that they treated management, rather than the audit committee (as representatives of investors), as the client. This mentality of treating the CFO as the client is so pervasive that it is reflected in practitioner guidance for selecting an external auditor. If auditors focus on winning engagements by courting management as the client, there is unlikely to be much gain from mandating audit firm rotation and/or having an audit committee make the auditor appointment decision. The audit committee will not be effective unless both auditors and audit committee members fundamentally change their mindsets about their respective roles vis-à-vis client management.

Studies of auditing generally equate auditor independence with audit quality, and researchers often attribute the inefficacy of regulatory reforms to the political power of the audit industry for adopting clever tactics to displace blame on individuals or other parties (Humphrey and Moizer 1990; Humphrey 2008). Our observations suggest that client management power, rather than audit industry politics, may be an important factor in undermining regulatory reforms. The market for audit services may demand other audit quality dimensions besides auditor independence, such as documentation and processes that produce legitimacy (Power 2003), expertise and advisory services, cost efficiency, and multinational capabilities (Jamal and Sunder 2011). Moreover, market participants may value these other quality dimensions because it is unclear whether *de jure* auditor independence reflects *de facto* independence. For example, Jamal and Sunder (2011) find that purchasers of certified baseball cards pay higher premiums for certifiers who are stricter graders, and that independent certification agencies (independent in appearance, in that they do not provide any other services) are not stricter graders. Although we cannot comment on the ultimate level of audit quality that followed the change in firms in our case study, the actions of the parties involved suggest a market demand for auditor attributes other than independence.

Because audit quality has multiple dimensions, regulators face difficulty in deciding how to trade off among desirable audit attributes. Taking audit partner rotation as an

example of trade-offs in setting regulation, the potential loss in expertise is small, while there is perhaps some gain in objectivity from having a fresh set of eyes (Tan 1995), and a clear gain in independence in appearance that bolsters legitimacy (Power 2003). Regulatory proposals that are more disruptive, such as mandating audit firm rotation and/or changing who appoints the auditor, present less clear trade-offs. The implementation of these measures is more complex and the outcomes are more uncertain. Advances in models of audit quality are needed, particularly with respect to trade-offs among independence dimensions (both de facto and de jure) for other dimensions, to better guide regulators in achieving the proper balance between professional and commercial considerations in auditing.

Several limitations of our study should be noted. Our selected case represents a single, large, publicly traded organization that granted us access to individuals and records. While other organizations might have more proactive audit committees, the observations in this study suggest that audit committees of large publicly traded companies do not always discharge their responsibilities in a substantive manner. Future research examining this topic can focus on a more representative selection of audit clients. A second limitation is that the discussions we had with management, the audit committee chair, and prospective audit partners were done after the decision had been made, and thus might not be completely “fresh” in their memories or may have been biased to serve their self-presentation concerns. While we attempted to reduce bias by obtaining written documents from both the company and prospective auditors, and by interviewing a range of participants, we report only ex post observations from all parties involved. Ideally, future studies will identify an RFP process while it is in progress, and negotiate access up front so the process can be studied in real time or immediately after auditor selection.

We terminate this study at the point when the company selects a new auditor. Though other researchers have investigated relationships and interactions among auditors and their clients during the audit engagement (e.g., McCracken et al. 2008; also, the negotiation model by Gibbins et al. 2001), future research should investigate how auditors’ relationships with management and the audit committee might unfold when a new auditor is engaged or when auditors make concessions to win a new client. Future research could also examine how auditors might provide client services differently for different types of clients, especially “top-tier clients” who are highly sought after by the Big 4 audit firms.

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SUPPORTING INFORMATION

Additional Supporting Information may be found in the online version of this article:

Appendix S1. Interview Script.

Appendix S2. X Company Request for Proposal.