



Original analysis on the latest happenings in the CFO industry

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BRIEF

Auditors penalized for highlighting companies' weak internal controls

124.79	4822.25	8725.89	8886.77	1.28	8796.05	8796.05	8886.05	8886.05	8886.05	8886.05
189.82	3482.43	3387.88	3871.91	1.17	3228.77	3228.77	3228.77	3228.77	3228.77	3228.77
39.74	139.79	139.54	139.79	0.02	2390.88	2390.88	2390.88	2390.88	2390.88	2390.88
76.55	7428.15	7270.15	7406.87	1.56	10120.61	10087.91	10452.81	10081.72	10359	
71.16	7869.43	7787.56	7835.02	0.33	7820.89	7820.28	7980.44	7811.9	795	
12.45	2622.04	2530.85	2606.8	2.67	7854.3	7833.4	8054.48	7827.02	791	
8.58	3651.06	3565.75	3636.12	1.6	7453.37	7433.51	7541.29	7427.06	75	
1.77	3082.38	3010.37	3069.73	1.59	6722.13	6715.81	6897.62	6707.04	68	
1.85	3822.14	3732.87	3806.45	1.59	7152.09	7137.46	7358.43	7134.41	71	
.78	419.87	408.76	419.28	2.56	6643.29	6628.72	6828.68	6623.66	6	
66	2902.28	2842.46	2891.99	1.42	4076.38	4058.9	4330.36	4055.2	4	
27	5633	5536.76	5608.05	1.09	4668.42	4678.11	4680.23	4522.67	4	
72	6979.49	6681.1	6920.02	3.16	1416.75	1422.12	1423.41	1327.77	4	
14	7229.17	7068.52	7191.05	1.42	11600.06	11601.88	11811.44	11590.76	4	
15	3156.84	3062.77	3135.81	1.82						
9	1882.61	1854.31	1875.92	1.04	2874.69	2869.5	2996.91	2867.74		
8	1834.06	1700.43	1828.89	1.93	3571.92	3557.61	3698.72	3554.56		
	3876.47	3802.4	3862.87	1.92	3024.81	3024.07	3085.97	3023.14		
	3876.47	3802.4	3862.87	1.92	3876.47	3862.8	3915.43	3859.43		

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Dive Brief:

- Auditors who call out material weaknesses in companies' internal controls over financial reporting are being penalized with a loss of business in what appears to be a form of retaliation, an academic study found.
- Auditors who issue an internal control material weakness (ICMW) note "are perceived as less attractive in the audit market," Elizabeth Cowle and Stephen Rowe of the University of Arkansas, who conducted the research, said.
- As a result, auditors are discouraged from "disclosing internal-control information that could make their clients look bad," Cowle and Rowe said.

Dive Insight:

The [Sarbanes-Oxley Act](#), enacted in 2002, requires auditors to call out companies with a material weakness in their internal controls. The law came about in the wake of Enron and WorldCom's high-profile failures, whose troubles, in part, were traced back to accounting audits that failed to catch early problems.

Under the act, auditors are required to call out material weaknesses if they believe a firm's control over their finances is flawed enough that a material financial misstatement could occur. But the law

has [been controversial](#) and auditors have been saying for years that companies penalize them when they apply the requirement.

"In the informal conversations we have had with practitioners, we've often found they already had a notion of what we document," Rowe said. "In other words, [concern over retaliation] is already part of the day-to-day calculus of many in the audit profession."

The study looks at roughly 5,000 office-years' worth of data from 885 offices of 358 audit firms in the U.S. from 2004 (the first year the material weakness opinions were required) to 2016.

Offices that reported internal control material weaknesses for one or more clients in a year saw growth in their average fee total in the following year shrink by about 8% less than if they had issued none.

That decline was in addition to lost fees from clients who were found to have internal control material weaknesses and responded by switching auditors; this is something companies tagged with ICMWs often do. "What our research measures is reputation," Rowe said. "When an auditor issues an ICMW opinion, word gets around."

Even in fairly large audit offices, the researchers said, results suggest a negative effect from a single ICMW opinion. In one year, the San Francisco office of one Big-4 audit firm issued no ICMW in the 12 public audits it conducted, while the bureau of another Big-4 in the same city reported one ICMW in 26 public audits. During the following year, the former saw a 17% increase in audits while the latter saw a 20% decrease.

The findings are being presented this week at the [American Accounting Association annual meeting](#) in San Francisco.