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Auditing

Fresh Evidence of Auditor Bias Emerges

Companies don't look good for penalizing honest auditors, while other auditors don't look good for rendering slanted opinions.

David McCann

"Don't Make Me Look Bad: How the Audit Market Penalizes Auditors for Doing Their Job."

That's the title of a study being presented at this week's annual meeting of the American Accounting Association. While it may not portray companies in the most favorable light, at the same time it's merely the latest suggestion that auditors might not necessarily lean toward rendering **unbiased opinions** on paying clients.

"Presumably, audits that provide useful information to users of financial statements should serve to increase the credibility of financial statements and, in turn, increase auditor reputation," the study's authors write.

But the research found exactly the opposite, at least with respect to one essential service auditors are required to perform: flagging material weaknesses in companies' internal controls over financial reporting, a responsibility mandated by the Sarbanes-Oxley Act (SOX).

Auditors judge such a material weakness to exist if a company's control of its finances is sufficiently flawed to create a reasonable possibility that a material financial misstatement will occur.

"Auditors who issue an ICMW are perceived as less attractive in the audit market," say co-authors Stephen Rowe and Elizabeth Cowle of the University of Arkansas. The perception "disincentivizes auditors from disclosing internal-control information that could make their clients look bad."

Indeed, the disincentive is considerable, judging by the study's comparison of companies that issue ICMWs in a given year with those that don't.

Based on 13 years of data from 358 U.S. audit firms, Rowe and Cowle found that offices of the firms that reported ICMWs for one or more clients during a year saw their average fee total in the following year grow by about 8% less than would have been the case had they issued none.

Moreover, that decline was *in addition* to lost fees from clients that were found to have ICMWs and responded by switching auditors, something companies tagged with ICMWs often do.

"The issuance of an ICMW affects auditor selection and retention decisions even among clients that do not receive an ICMW," the study states. To which Rowe adds: "What our research measures is reputation. When an auditor issues an ICMW opinion, word gets around."

The study's findings, he continues, will come as no surprise to many auditors: "In the informal conversations we have had with practitioners, we've often found they already had a notion of what we document."

Allegedly lax audit practices have lately been much in the news as a result of **a lawsuit** against PricewaterhouseCoopers by a whistleblower who was formerly a senior manager there. Among other things, he charges that to keep managements of corporate clients happy, PwC has customarily pulled its punches in audits of their internal controls.

Additionally, the Securities and Exchange Commission is currently weighing an exemption from IC audits for more than 350 medium-sized public companies. That represents a response to complaints that the SOX-mandated external audits impose an expensive burden on many companies with little benefit to investors.

Meanwhile, however, the Public Company Accounting Oversight Board, the auditor watchdog body, recently *expanded* the scope of required auditor-to-investor communication.

The PCAOB's **new regulations** require companies disclose in their annual reports so-called **critical audit matters** (CAMs) — that is, complex or challenging issues auditors convey to company audit committees.

One Is a Lonely Number

The researchers analyzed about 5,000 auditor office-years of data from 2004 through 2016. Even in fairly large offices, results suggested a considerable negative effect from a single ICMW opinion.

For example, in one year the San Francisco office of Big Four firm issued no ICMWs in the 12 public audits it conducted, while the bureau of another Big Four in the same city reported one ICMW in 26 public audits. During the following year, the former issued 14 audit opinions, an increase of about 17%, while the latter issued 21, a drop of almost 20%.

The researchers found numerous factors that further worsened the negative effects on auditors' client numbers and fees: (1) when an office issued two or more such reports; (2) when ICMWs were issued for large companies; and (3) when ICMW reports involved multiple issues (the more issues, the more negative the effect).

Also, (4) companies in the sample that switched offices migrated mainly to auditors with lower incidences of ICMWs; (5) the ratio of clients with high F-scores (that is, with heightened likelihood of manipulating or misstating earnings) tended to drop when an office issued an ICMW; and (6) that the negative after-effect on auditors' business following ICMW opinions persists to a second year before apparently petering out.

"Sarbanes-Oxley represented the principal legislative response to a severe crisis not only for the accounting profession but for the free-market system," says Rowe. "While some studies have found SOX to be of value, the issue, as this study suggests, is far from settled. To anyone who believes in the free-market system, this needs to be concerning."

The paper is among hundreds of scholarly studies being presented at the American Accounting Association conference in San Francisco from Aug. 9-14.