

# THOMSON REUTERS

## TAX AND ACCOUNTING

AUGUST 21, 2019

### *Auditors Who Do Their Jobs Are Penalized, Study Indicates*

No good deed goes unpunished. And it apparently applies to auditors.

When an auditor discloses material weaknesses of a public company client's internal control over financial reporting (ICFR), a study found that ironically the auditor ultimately suffers.

Congress passed the Sarbanes-Oxley Act in 2002 to help prevent the types of accounting scandals that brought down Enron and WorldComm almost two decades ago. One of the provisions, Section 404, requires management and auditors to check the company's financial controls to lower the risks of financial misstatements.

"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 for providing a valuable audit," a July 2019 paper noted. "However, as noted by former board member of the PCAOB, Daniel Goelzer, in a speech detailing the costs and benefits of SOX 404, many contend that SOX 404 has resulted in unintended consequences and erected a 'wall between auditors and clients.'"

The research by Elizabeth Cowle and Stephen Rowe of the University of Arkansas was presented at the **American Accounting Association** annual meeting in San Francisco from August 9 to 14.

Public company clients that receive a material weakness in internal control are subject to many economic costs, including negative stakeholder reactions and increased costs of both debt and equity, the study said.

"Thus, the economic costs associated with receiving ICMWs could motivate clients to avoid receiving ICMWs [internal control material weaknesses] and discourage clients from retaining/selecting auditors with a reputation for issuing ICMWs," Cowle and Rowe wrote in their paper.

Auditors flag material weakness if the company's control is sufficiently flawed to create a reasonable possibility that a material financial misstatement will occur.

To study the audit market implications for auditors that have a reputation for being critical of clients, Cowle and Rowe examined growth in audit clients and fees for audit offices that issue ICMWs. They found that on average, for every additional ICMW issued, an audit office experienced 2.2 percent lower client growth and 6.1 percent lower fee growth over the next year.

This decline was in addition to lost fees from clients who were found to have ICMWs and switched auditors. Companies who are flagged with ICMWs often dismiss their auditors.

"This finding suggests that auditors who issue an ICMW are perceived as less attractive in the audit market and indicates that the issuance of an ICMW affects auditor selection and retention decisions even among clients that do not receive an ICMW," the study noted. This in turn disincentivizes auditors from disclosing internal control information that could make their clients look bad.

"This trend may have contributed to the overall decline in ICMWs, which as of 2018 represented just 4.87% of total SOX 404 opinions, compared to 15.88% following the enactment of SOX," the paper says. "Our findings should inform regulators about additional indirect costs associated with SOX 404 provisions and speak to some potential implications of the requirements of the newly enacted expanded auditor's report."

They were making a reference to the PCAOB's requirement that auditors add a description of critical audit matters (CAMs) in auditor reports that accompany financial statements. The audit regulatory board defines critical matters as issues that have been communicated to the audit committee, are related to accounts or disclosures that are material to the financial statements, and involved especially difficult judgment from the auditor. The rule became effective for audits of large accelerated filers for fiscal years ending on or after June 30, 2019.

Separately, the SEC is considering providing an exemption to more categories of companies from the auditor attestation of management's internal controls.

The researchers used a sample of 885 audit offices of 358 audit firms and their clients from 2004 to 2016.

© 2019 Thomson Reuters/Tax & Accounting. All Rights Reserved. |