CFO DIVE

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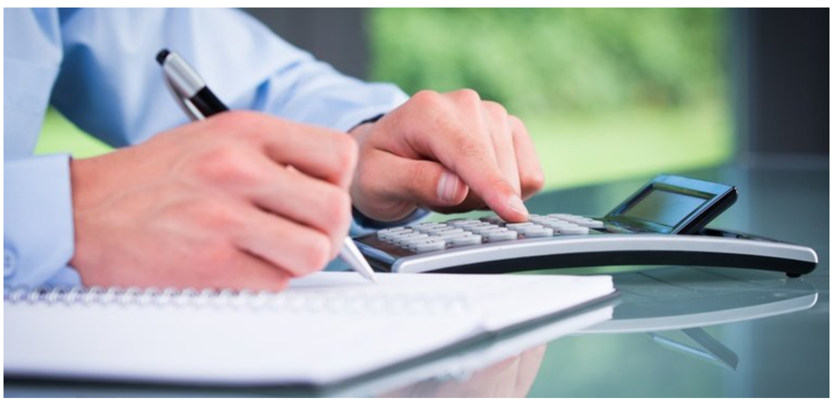
BRIEF

Audit quality improves when former partners sit on audit committee



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Dive Brief:

- Counter to a widespread impression that audit quality diminishes when a former partner of the audit firm sits on the audit committee of the company being audited, audit quality actually goes up, researchers have found.
- On average, companies with an affiliated audit committee member were 21% less likely to misstate their financial results and 26% less likely to be late in reporting material weaknesses in their reporting systems.
- The reason: an affiliated audit committee member works with the audit firm to conduct the appropriate audit procedures, not merely more tests. “Having an audit committee member with personal, in-depth knowledge of the audit firm” is a virtue, say the researchers.

: **Dive Insight**

The study’s findings are based on data from 4,906 companies audited by one of the Big 4 auditing firms — KPMG, Ernst & Young, Deloitte and PricewaterhouseCoopers — during the nine years starting in 2004, the second year following passage of the

Sarbanes-Oxley Act. That law charges audit committees with responsibility for the quality of corporate financial reporting.

Under the study, about 6% of the companies had an audit-committee member who was a former partner of the Big-4 firm conducting the audit, 12% had a member who was a former partner of another Big-4 firm, and the remainder had no former Big-4 partner on the audit committee.

The researchers assessed the quality of companies' annual financial statements, the incidence of dismissals of audit firms, the size of audit fees, and the length of any reporting lag. They concluded companies with an affiliated audit committee member showed —

- Less likelihood of misstatements and of belated reporting of material weaknesses
- Less likelihood of audit-firm dismissal
- Lower audit fees

They also found no significant relationship between audit quality and the presence on the audit committee of a non-affiliated former Big-4 partner.

Past studies have contributed to the view affiliated audit committee members are bad for audits by finding these firms less likely to challenge companies' aggressive accounting decisions. But the current study counter-balances that view, for two reasons:

- When an affiliated partner serves on the audit committee, the committee's financial reporting quality objectives align with the audit firm.
- Affiliated partners can use their knowledge of, and identification with, the audit firm to improve the audit process and the communication between the two parties.

"Thus [they] are likely to improve audit quality," said the researchers, Thomas Omer and Marjorie Shelley of the University of Nebraska—Lincoln, Brant Christensen of the University of Oklahoma, and Paul Wong of the University of California, Davis.

The study appeared in **Auditing: A Journal of Practice and Theory**, published by the **American Accounting Association**,