THE WALL STREET JOURNAL

CFO JOURNAL

NOVEMBER 1, 2018

RISK

The ‘Dark Side’ of Managers With Audit Background

Higher pay and audit-firm experience could raise risk of misstatements, research indicates

A jar filled with money sits on a shelf in East Derry, N.H. on June 15, 2018. A new study found that the combination of excess compensation and an audit-firm background among top executives increased the likelihood of financial restatements

By Tatyana Shumsky

Handing large paychecks to corporate executives with audit-firm experience could raise the risk of financial misstatements, according to new research.

Companies that gave top managers above-average compensation and whose executives had an audit-firm background were about 30% more likely than those with lower-paid counterparts to misstate financial results, according to a study in the November issue of **The Accounting Review.** The study examined more than 3,000 public companies over a 10-year period.

The combination of audit-firm experience and excess pay brought out this "dark side" of accounting competence and raised the risk of misstatements, said Anne Albrecht, an assistant professor of accounting at the Neeley School of Business at Texas Christian University, who is one of the study's authors.

"Accounting competence is good because they're able to generate more reliable financial statements," she said. "But it's bad because the knowledge of accounting procedures allows them to make the misstatements in the first place, and their knowledge of the auditing process allows them to hide it."

Moreover, executives with an audit background were more likely to engender trust from the company's current auditors, resulting in a higher rate of clean audit opinions, the study found. "That shared background generates trust so that auditors aren't necessarily as skeptical of management as perhaps they should be," Ms. Albrecht said.

Researchers looked at corporate officers, such as finance chiefs or chief executives, to determine accounting competence. If the executive had prior experience as an audit partner or manager at a public accounting firm, they were considered competent.

The authors then compared pay among executive teams to establish an average compensation, adjusted for factors such as accounting competence, executive tenure at the company, and company performance within its industry. If the actual compensation was above the predicted amount, the management team was deemed to have received "excess compensation."
In any given year, about 12% of the companies had one or more top executive with prior audit experience as partner or manager at an accounting firm. Of those executives, roughly 60% were CFOs and 9% were CEOs.

Overall, the financial restatement rate was about 10% for all the companies analyzed during the 10-year period. For firms that had executives with an audit-firm background, the restatement rate was 9.5%.

However, companies that had executives with both an audit-firm background and high excess compensation, the restatement rate was 11% during the 10 year period, compared to 8% for firms that had managers with accounting competency and low excess compensation.

For board members and audit committees, the study shines a spotlight on a potential risk, said Howard Brownstein, president of the Philadelphia chapter of the National Association of Corporate Directors and a NACD board leadership fellow.

“If there’s a risk that you have very competent people who know how to game the system, you need very strong systems and controls,” Mr. Brownstein said. “It’s not about accusing them of being dishonest, it’s about keeping them from being tempted.”

Write to Tatyana Shumsky at tatyana.shumsky@wsj.com.