

# COMPLIANCE WEEK

THE LEADING INFORMATION SERVICE ON CORPORATE GOVERNANCE, RISK AND COMPLIANCE

## ACCOUNTING & AUDITING

### Market punishes auditors who flag control issues, study says

Tammy Whitehouse | August 13, 2019

**Auditors seem to be caught between a rock and hard place—getting grief from regulators if they don't flag internal control weaknesses but suffering setbacks in the marketplace if they do**



A new **academic study** presented to the **American Accounting Association** out of the University of Arkansas finds auditors who flag **material weaknesses in internal control** get penalized by the market. Auditors who issue a material weakness finding with respect to a company's internal controls "are perceived as less attractive in the audit market," say co-authors Stephen Rowe and Elizabeth Cowle, which "disincentivizes auditors from disclosing internal-control information that could make their clients look bad."

That seems to fly in the face of the objectives of Sarbanes-Oxley, which was to dispatch auditors to more closely scrutinize controls in the interest of investors, who are the key consumers of financial reporting. The Public Company Accounting Oversight Board, formed under SOX, has been **delivering harsh findings** to audit firms for several years where they **fail to adequately scrutinize** a company's accounting, particularly its internal control over financial reporting.

The study examines 13 years of data from 885 local offices of 358 U.S. audit firms. It finds that offices that reported material weaknesses for one or more clients in the

course of a year saw their average fees in the following year grow by 8 percent less than if they had issued no adverse findings. That decline was in addition to lost fees from client companies that were found to have internal control weaknesses and responded by changing auditors, the study finds.

The research seems to provide an indicator of audit firm reputation, the authors say. “When an auditor issues an ICMW opinion, word gets around,” they wrote.

The findings will likely not surprise auditors, the authors say. “In the informal conversations we have had with practitioners, we’ve often found they already had a notion of what we document,” they say. “In other words, what we’ve been the first to do in this study is provide confirmation on a large scale for what is already part of the day-to-day calculus of many in the audit profession.”

The study cites as support a lawsuit currently facing PwC in which a senior manager claims he was fired for too aggressively pursuing control failures and weaknesses. In ***Botta vs. PricewaterhouseCoopers***, the former auditor says he was removed from an audit because his supervisor made it clear the firm had to raise the precision threshold of control issue so it would pass, lest the firm issue a material weakness that would have harmed the firm in the marketplace. The case is scheduled for trial in October.



**Tammy Whitehouse**

Tammy Whitehouse is a veteran business writer who has been a regular contributor to Compliance Week since 2005, with a focus on covering accounting and audit.