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## **Auditors reporting weaknesses are “less attractive”, study says**

US auditors who report material weaknesses in companies' internal controls over financial reporting are seen as “less attractive” by current and potential clients

The knock-on effect, according to new research from the US, is that their reputations are damaged even though they are providing useful information for users as well as complying with the law.

Worse, it provides auditors with an incentive not to disclose information about internal controls which could show their clients in a negative light.

Research co-authors Stephen Rowe and Elizabeth Cowle of Arkansas University studied data gathered over 13 years from 885 local offices of 358 audit firms in the US. They found that audit firms which reported material weaknesses in internal controls (ICMW) for one or more clients over a 12-month period experienced slower fee income growth - by around 8% - than they would have done had they not made the reports.

Furthermore, the deceleration in growth came on top of lost audit fees since most companies with an audit disclosing ICMWs end up changing auditors.

But it doesn't stop there. The academics found that issuing an ICMW impacts auditor selection and retention decisions among other clients: even if they haven't been issued with one, the perceived threat seems to put them off. “What our research measures is reputation,” said Rowe. “When an auditor issues an ICMW, word gets around.”

The academics cite the example of two Big Four firms in San Francisco. One firm's office issued no ICMW in the 12 public audits it carried out while the other issued one out of 26 public audits. The following year, the first firm's office issued 14 audit opinions (up 17%) while the other issued 21 audit opinions (down almost 20%).

The impact on fees gets worse the more ICMWs a firm discloses and the larger the company involved. The negative effect on an auditor's business lasts for at least two years after the disclosure before "petering out".

The findings will prove to be of interest to the profession in the US, not least because Big Four firm PwC is currently embroiled in a lawsuit with a former senior manager and whistle-blower, Mauro Botta.

After 12 years of auditing Silicon Valley technology companies, Botta compiled a dossier of negligent book-keeping and weak internal controls among small to medium-sized companies there, which he sent to the US Securities and Exchange Commission (SEC). More importantly, he accused PwC of pulling its punches when it came to flagging problems with audit clients' internal controls.

At the same time, the SEC is considering a proposal to exempt 350 mid-sized listed companies from internal control audits on the grounds that the exercise, which was originally imposed by Sarbanes-Oxley (SOX), has proved costly and of little benefit to users.

In contrast, the audit regulator, the Public Company Accounting Oversight Board (PCAOB), has recently introduced new regulations requiring auditors to discuss critical audit matters covering challenging issues reported to the audit committee.

The PCAOB's move may not turn out to be as informative as anticipated. Cowle and Rowe point out that their findings about ICMWs "suggest that market-based incentives may discourage auditors from disclosing important direct-to-investor communications that might make their clients look bad, and instead encourage auditors to withhold such information".

The findings will also resonate over in the UK where, following his review of the Financial Reporting Council, Sir John Kingman recommended that the Department for Business, Energy and Industrial Strategy "should give serious consideration to the case for a strengthened framework around internal controls in the UK, learning any relevant lessons from operation of the Sarbanes-Oxley regime in the US".

As far as Rowe and Cowle are concerned, the jury is still out. "Sarbanes-Oxley represented the principal legislative response to a severe crisis not only for the accounting profession but for the free market system.

"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."

Rowe and Cowle presented their research today at the [American Accounting Association's](#) annual meeting in San Francisco.