

AUGUST 13, 2019

Companies are pressuring auditors to leave criticism out of audit opinions, research finds

Companies shop for auditors that go easy on management and fire them for too much disclosure of internal control weaknesses



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Audit firms are finding it can cost them if they criticize their clients

Companies pressure auditors on fees and even fire them when they disclose information that's critical of management in their audit opinions, according to new research.

The penalties are even bigger for auditors who step up and do their job when the client is more well-known and the criticism is more severe, according to the working paper, "Don't make me look bad: How the audit market penalizes auditors for doing their job," by Elizabeth N. Cowle and Stephen P. Rowe, professors of accounting at University of Arkansas. The research is being presented on Tuesday at the **American Accounting Association's** annual meeting in San Francisco.

The Sarbanes-Oxley Act of 2002, that was passed after the failure of energy trading giant Enron and the accounting frauds at companies that went bankrupts such as WorldCom and HealthSouth, includes a provision called SOx 404 that requires auditors to provide an opinion on internal controls over financial reporting, or ICFR. The purpose is to inform investors about weaknesses in a company's internal controls that might lead to errors or fraud in financial reporting.

Three years after the passage of the Sarbanes-Oxley law, former Public Company Accounting Oversight Board member Daniel Goelzer detailed his view of the costs and benefits of SOx 404 in a speech, and said many believed that SOx 404 had resulted in unintended consequences and erected a "wall between auditors and clients."

But Goelzer penned a blog post in July quoting a study that says auditors are obsessed with pleasing the PCAOB, the independent audit regulator established by the SOx law, and not the clients, and that's driven some "to engage in elaborate prediction strategies" to identify which audits and which audit issues are likely to be selected for inspection.

Goelzer, and the researchers, are referring to the efforts by KPMG and its partners to steal confidential information about PCAOB audit inspection plans in a "cheat the test" scheme uncovered by a KPMG whistleblower in early 2017. That resulted in the criminal prosecution of five former KPMG professionals and one former PCAOB inspector and, recently a \$50 million fine from the SEC for the firm for an internal test-cheating scandal, along with the PCAOB-related violations.

Cowle and Rowe say companies initially select their auditor, and decide whether to keep them, largely based on the auditors' reputations. When an auditor issues an internal control material weakness, or ICMW, that should tell the company and investors that the auditor conducted its work well enough to identify a weakness and then communicated that information to investors via its opinion. In other words, it should enhance its reputation for competency, objectivity and professionalism, and not detract from its reputation.

However, other research has found that ICMWs damage client reputations, and sometimes share price, and that the reputational impact of ICMWs for the client and auditor diverge — they are bad for clients and neutral or positive for auditors.

Supplemental analyses by Cowle and Rowe found evidence that companies at greater risk of ICMWs avoid hiring auditors with a reputation for issuing them. Prior studies have shown that information provided directly by auditors regarding weaknesses in internal controls over financial reporting is valued by investors but management actively avoids these disclosures by opinion shopping.

The economic costs of ICMWs could motivate clients to try to avoid receiving ICMWs and discourage them from retaining/selecting auditors with a reputation for issuing the criticism, the researchers contend. That's because ICMWs increase the cost of both debt and equity and cost companies money for more audit work.

The researchers note that a recent SEC whistleblower, Mauro Botta, filed a complaint with the SEC concerning his experiences as a senior manager with several

PricewaterhouseCoopers LLP Silicon Valley audit clients, alleging that the auditor overlooked material weaknesses to “keep corporate managers happy” and “compete with other audit firms.”

If the market for audit services penalizes auditors for providing the public with value-relevant information that is critical of management, for example ICMWs, then the market actively undermines the potential value of auditors’ direct-to-investor communications.

If that is happening it’s also happening just when auditors are being asked to provide even more direct communication in the form of CAMs or critical audit matters, a recent mandated expansion of the independent external auditor’s report. Auditors are now required to provide more information about their assessment of risk and their auditing approach to those increased risks, but that information that may also be critical of management’s accounting judgment.

Even though CAMS should, in theory, “enhance the informativeness of the audit report,” the researchers caution that their findings suggest that business priorities “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.”