CPA Practice Advisor

AUGUST 12, 2019

ACCOUNTING & AUDIT

How the Audit Market Penalizes Auditors for Doing Their Job

BY BEN HAIMOWITZ

What earns auditors a good reputation? Common sense suggests that being of service to investors should go a long way toward that end. In the words of a study being presented at this week's annual meeting of the **American Accounting Association,** "Presumably, audits that provide useful information to users of financial statements should serve to increase the credibility of financial statements, and, in turn, increase auditor reputation."

But the research then proceeds to find exactly the opposite with respect to at least one essential service auditors are required to perform – flagging material weaknesses in companies' internal controls over financial reporting, a responsibility mandated by the controversial Sarbanes-Oxley act (SOX) of 2002. A material weakness (ICMW) is judged by auditors to exist if a firm's control of its finances is sufficiently flawed to create a reasonable possibility that a material financial misstatement will occur.

Thus the new study's title: "Don't Make Me Look Bad: How the Audit Market Penalizes Auditors for Doing Their Job."

In the words of co-authors Stephen P. Rowe and Elizabeth N. Cowle of the University of Arkansas, "The issuance of an ICMW should neither impair the issuing auditor's reputation, nor deter clients from selecting auditors with a history of issuing ICMWs." Yet, "auditors who issue an ICMW are perceived as less attractive in the audit market," which therefore “disincentivizes auditors from disclosing internal-control information that could make their clients look bad."

Indeed, the disincentive is considerable, as becomes clear from the study’s comparison of firms that issue ICMWs in a given year with those that don’t. Based on 13 years' data from 885 local offices of 358 audit firms in the U.S., Rowe and Cowle find that offices which reported ICMWs for one or more clients in the course of a year saw their average fee total in the following year grow by about 8% less than would have been the case had they issued none. Moreover, that decline was *in addition* to lost fees from clients who were found to have ICMWs and responded by switching auditors, something companies tagged with ICMWs often do.

In short, "the issuance of an ICMW affects auditor selection and retention decisions even among clients that do not receive an ICMW," the study states. To which Prof. Rowe adds: "What our research measures is reputation. When an auditor issues an ICMW opinion, word gets around."

The study's findings, he continues, will come as no surprise to many auditors. "In the informal conversations we have had with practitioners, we’ve often found they already had a notion of what we document. 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 paper is likely to resonate with particular force among attendees of the American Accounting Association meeting for several reasons.

■ One is that lax audit practices have lately been much in the news as a result of a lawsuit being waged against Big-4 accountant PwC by a whistleblower who was formerly a senior manager there. Among other things, he charges that, to keep managements of corporate clients happy, PwC has customarily pulled its punches in audits of their internal controls.

■ A second reason is that the U.S. Securities and Exchange Commission is currently considering exempting from IC audits more than 350 medium-sized public companies. The change, if adopted, would represent a response to complaints that, in requiring external audits of corporate internal financial controls, SOX has imposed an inordinately expensive burden on many firms with little benefit to investors.

■ Meanwhile, as the SEC ponders *narrowing* that mandate, its regulatory junior partner, the Public Company Accounting Oversight Board (PCAOB), recently *expanded* the scope of required auditor-to-investor communication. Its new regulations require disclosure in company annual reports of so-called “critical audit matters” (CAMs) – that is, complex or challenging issues auditors convey to company audit committees. Taking a cue from their findings about ICMWs, Rowe and Cowle express doubt about the new mandate. Although the requirement, they write, "should in theory enhance the informativeness of the audit report, our findings pertaining to 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."

In total, the researchers analyzed about 5,000 office-years' worth of data spanning 2004 (the first year when IC opinions became available following passage of Sarbanes-Oxley) through 2016. On average, about 25% of the bureaus issued at least one ICMW opinion per year. Since only offices with more than three clients were included in the sample, one ICMW opinion could affect as many as 25% or as little as 2 or 3% of a bureau's clients.

Even in fairly large offices, results suggest a considerable negative effect from a single ICMW opinion. For example, in one year the San Francisco office of one Big-4 firm issued no ICMW in the 12 public audits it conducted, while the bureau of another Big-4 in the same city reported one ICMW in 26 public audits. During the following year, the former issued 14 audit opinions, an increase of about 17%, while the latter's fall-off in business was such that it issued 21 audit opinions, a drop of almost 20%.

In addition to finding significant negative impacts on client numbers and fees in the year following as little as a single ICMW report, the researchers discovered both impacts to worsen even more 1) when an office issued two or more such reports; 2) when ICMWs were issued for large companies (higher market capitalization, and likely more visibility, than the median of an office's clients); and 3) when ICMW reports involved multiple issues (the more issues, the more negative the effect).

Rowe and Cowle also found 4) that companies in the sample who switched offices migrated mainly to auditors with lower incidences of ICMWs; 5) that the ratio of clients with high F-scores (that is, with heightened likelihood of manipulating or misstating earnings) tended to drop when an office issued an ICMW; and 6) that the negative after-effect on office business of ICMW opinions persists beyond the subsequent year to a second year before apparently petering out.

In sum, 17 years after the passage of SOX the study raises fresh doubts about the still-controversial bill as well as about the new PCAOB mandate on CAMs that the authors see as having evolved from it. These doubts, they believe, ought to be of serious concern. Comments Prof. Rowe: "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."

The paper will be among hundreds of scholarly studies presented at the **American Accounting Association** annual meeting, which is expected to attract some 4,000 scholars and practitioners to San Francisco from August 9th to 14th. The AAA is a worldwide organization devoted to excellence in accounting education, research, and practice. Journals published by the AAA and its specialty sections include *The Accounting Review, Accounting Horizons, Issues in Accounting Education, Behavioral Research in Accounting, Journal of Management Accounting Research, Auditing: A Journal of Practice & Theory, The Journal of the American Taxation Association, Journal of Financial Reporting,* and *Journal of Forensic Accounting Research.*