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It Turns Out Clients Really Don’t Like It When Auditors Call Them Out on Their Sh*t

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In shocking research presented earlier this month at the **American Accounting Association’s** annual meeting in San Francisco, Elizabeth N. Cowle and Stephen P. Rowe of the University of Arkansas have confirmed suspicions that clients shun audit firms with a reputation for being hard-asses.

Let’s check out the abstract:

> We examine whether the audit market penalizes auditors for providing investors with value-relevant information that is critical of management (i.e., internal control material weakness (ICMW)). While prior research has examined how the receipt of an ICMW increases the likelihood that a client leaves their auditor, we examine the reputational impact of an office issuing ICMWs by focusing on clients that receive clean internal control opinions. We predict and find that audit offices that issue more ICMWs experience lower client and fee growth. We also find that the

decrease is stronger when the ICMW is associated with a more visible client and when the ICMW is more severe. In supplemental analyses we find evidence consistent with clients avoiding auditors with a reputation for issuing ICMWs in their auditor selection decisions. Our results indicate that, on average, the market for audit services penalizes auditors for disclosing information critical of management in their audit opinions, which undermines the value of direct-to-investor auditor communications and provides insight into potential longer-term implications of the recently enacted expanded auditor's report.

Up until now, no one has really examined how direct-to-investor affects auditors' client prospects, though earlier research determined that management really doesn't like ICMW disclosures (because duh). As the current research points out, ICMWs are, on the whole, good for the auditor as they can say "hey, we did our job and found this." For clients, however, ICMWs are a sign that the client needs to get better at *their* job when it comes to internal financial reporting. As Dan Goelzer, former acting chairman of the PCAOB, said in 2005, "management needs to perform its own control evaluation; it can't delegate that responsibility to the auditor or treat the auditor as part of the controls by relying on it to catch errors."

An auditor's issuance of an ICMW indicates that the auditor conducted the audit sufficiently well to identify a weakness and then communicated that valuable information to the public. Thus, to the extent that clients value providing useful information to users of financial statements, the issuance of an ICMW should neither impair the issuing auditor's reputation for quality, nor deter clients from selecting auditors with a history of issuing ICMWs. However, ICMWs signal poor internal financial reporting quality that research has found damages client reputations (e.g., Ashbaugh-Skaife et al., 2009; De Franco et al., 2005; Kim et al., 2011). Thus, the implications of an ICMW diverge for the auditor and client (negative for the client and neutral or positive for the auditor).

Now, how about some actual numbers? Researchers found that for every additional ICMW issued, an audit office experiences 2.2% lower client growth and 6.1% lower fee growth over the next year.

Additionally, to the extent that an ICMW reflects an auditor's willingness and ability to provide valuable information to investors, our findings suggest that clients (on average) may avoid certain auditors during their auditor selection process. This trend may have also contributed to the overall decline in ICMWs, which as of 2018 represented just 4.87% of total SOX 404 opinions, compared to 15.88% following the enactment of SOX (Audit Analytics, 2018).

If that sounds a little far-fetched, one need look no further than the Botta v. PwC case to see evidence of a "client first" approach when it comes to doing the job auditors are hired (and regulated) to do.

> Some of these costs are explicitly highlighted in a recent whistleblower case, Botta v. PricewaterhouseCoopers LLP (Botta v. PwC), which alleges that auditors overlooked internal control issues to curry favor with companies' management and remain competitive in the market. Under penalty of perjury, former Big 4 senior manager, Mauro Botta, contends that auditors have breached their duty as public watchdogs by withholding valuable information from stakeholders, particularly with regard to companies' internal control opinions. Botta alleges he was reprimanded on numerous occasions for pointing out companies' control failures and weaknesses. In one instance, Botta asserts that when he pointed out one company's "internal controls were failing, inadequate, and not accurate," his supervisor "specifically instructed [Botta] to make it seem as the severity of the issue was not material" (Botta v. PwC, 2018). In further admonishment for raising concerns about potential control issues, Botta alleges he was removed from a client at the request of the CFO, instructed to "raise the threshold of precision of the control to make it pass," and told by one partner at the firm that "we cannot issue a material weakness otherwise we would not have been market competitive" (Botta v. PwC, 2018). Taken together, this purported behavior highlights previously overlooked reputational effects of auditors revealing information that could make companies look bad.

We'll hear more on that case when it goes to trial in October.

Overall, the research seems to point to an uncomfortable situation where audit firms are discouraged from making important disclosures lest they find themselves down a client for it. It will be interesting to see where this research leads and how the profession addresses what appears to be a critical failure in the auditor-client relationship.

Check out the full text of *Don't Make Me Look Bad: How the Audit Market Penalizes Auditors for Doing Their Job* here.