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## **Companies Appear to Avoid Hiring Auditors With a History of Critical Audits, New Research Shows**

Audit committees need to do more to prevent companies from acting on bias, according to researchers who examined data from more than 350 U.S. audit firms over 13 years

*By Mark Maurer*

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There is a paradox in auditing, new research indicates: Audit firms that do a thorough job examining clients' financial statements could be doing so at their own peril.

Audit firms, on average, suffer a drop in future client growth and revenue growth after detecting a material weakness in a company's financial reporting, according to a study of more than 350 U.S. audit firms over 13 years.

Companies appear to avoid hiring auditors that have a history of critical audits at other companies, though firings because an auditor found a material weakness aren't as apparent, the study said. Therefore, some auditors have trouble attracting new clients, according to the study, which was led by University of Arkansas accounting professor Stephen Rowe and accounting Ph.D. candidate Elizabeth Cowle.

The authors were scheduled to present their findings Tuesday at an annual American Accounting Association conference in San Francisco, the organization said.

The study tracked the issuance of "internal control material weaknesses," or ICMWs, which are critical of management, from 2004 to 2016. If a regional office of an audit firm issues a single

ICMW, for example, it leads to a 2.5% lower growth in the number of clients and an 8% decline in year-over-year revenue for that office, the study found.

Rather than criticize company executives for acting on bias, the study lays the blame on boards of directors, whose audit committees make decisions on hiring or firing auditors. “The committee has ultimate responsibility in determining how effective the auditor is at the job,” said Daniel Goelzer, a retired partner at Baker & McKenzie and former interim chairman of the Public Company Accounting Oversight Board.

Mr. Rowe, the co-author, said he hopes the study will effect change among audit committees. “When audit committees are working with management to choose an auditor, it would be nice if they were more aware of the company’s bias and evaluated all factors when making the decision,” he said in an interview.

Companies avoiding diligent audit firms could have a detrimental impact on investors’ access to relevant company information, Mr. Rowe and Ms. Cowle wrote.

“If the market for audit services penalizes auditors for providing the public with value-relevant information that is critical of management (i.e., ICMWs), then the market actively undermines the potential value of auditors’ direct-to-investor communications,” the researchers wrote.

One regulator has made an effort to make audits more detailed. The PCAOB, which regulates the U.S. accounting industry, this year began requiring that auditors for large companies include information on [the most complex issues](#) about a company in their annual letter in financial statements.

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