

# AGENDA

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## Tracking “Bad Actor” Audit Engagement Partners

By Lindsay Frost October 14, 2019

New research suggests that there is no direct link between audit partner disclosures and audit quality, an assumption behind the **Public Company Accounting Oversight Board**'s new requirement that auditing firms name the partner engaged in each audit in **SEC** filings. However, sources say the new disclosures can provide directors with a valuable jumping-off point when selecting a new auditor.

Indeed, companies and investors alike can use the disclosures to track audit partner performance as part of their evaluation of audit firms. In certain cases, they say, the disclosures are even driving “against” votes on auditor ratifications.

“This is at the root of ‘where does the buck stop?’” says **Sandy Peters**, head of financial reporting policy at the **CFA Institute**. “You can now know who signed that audit opinion.”

The PCAOB's Rule 3211 went into effect in early 2017 and directs audit firms to publicly disclose the name of the engagement partner who signed off on a company's audit through a separate disclosure called Form AP. The audit firm files its Form AP when it files its audit opinion in SEC filings for each company.

“[This rule] makes engagement partners understand that just like the CFO, controllers and CEOs, your name is going to be on this, so we know who you are,” Peters says. “It looks at behavior and accountability over time.”

### Transparency Tool

Also as part of new rules, the PCAOB now requires the disclosure of specialists or other firms used in the audit as well as the audit firm tenure. It also recently started requiring audit firms to disclose critical audit matters (CAMs).

Though the suite of rules was designed to drive improvements in quality, research suggests there is little connection between audit partner disclosure and audit quality so far. In the study, “What's in a Name? Initial Evidence of U.S. Audit Partner Identification Using Difference-in-Differences Analyses,” co-author **Lauren Cunningham**, assistant professor and director of research at the Neel Corporate Governance Center at the **University of Tennessee**, looked at audit quality based on several factors.

The factors included performance-matched discretionary accruals, the probability of accounting misstatements and the likelihood of issuing an incorrect material weakness opinion under

internal controls over financial reporting (ICFR) rules, according to the paper, which was published in *The Accounting Review*, the peer-reviewed journal published by the **American Accounting Association**.

Cunningham and co-authors **Chan Li**, accounting professor at the **University of Kansas**; **Sarah E. Stein**, accounting and information systems professor at **Virginia Tech**; and **Nicole Wright**, accounting professor at **James Madison University**, used various control groups, including companies that already disclosed audit engagement partner names before the rule went into effect. Ultimately, the research showed that audit quality is based on specific company characteristics, control group characteristics and the specific metrics of quality measured.

That said, according to Cunningham and others, the disclosure can still be helpful for audit committees.

For example, current PCAOB rules direct companies to rotate engagement partners every five years. Now, when audit committees are considering hiring a new firm or a specific partner, they can search through the PCAOB's database of engagement partners by name, audit firm or company through the AuditorSearch tool on the PCAOB's website.

Audit committees now have a "clean data set and the ability to look at the track record," Cunningham says. For example, audit committees can look into why a partner was involved in a restatement, and dig into the causes behind it, she says.

Indeed, the study notes that one of the many unanswered questions about the Form AP disclosures is, "Will audit committees seek out (or avoid) engagement partners who are viewed as performing consistently high-quality ([or] low-quality) audits?"

**Phillip Austin**, national assurance managing partner for auditing at **BDO**, cautions that the data should "inform a line of questioning" from the audit committee but shouldn't necessarily "suggest a particular answer."

"Because the partner was nearby when something occurred like a material weakness or a restatement, that doesn't mean that partner didn't do their role well. In fact, it may be a functioning of them doing it well that led to the information becoming present in the market," Austin says. "If I was on an audit committee of a sophisticated company seeking to appoint a new engagement partner or firm, I would think the engagement partner information is a piece of data that helps me think about that decision."

Meanwhile, to investors, Peters says the disclosure provides "a greater degree of accountability." Not only can investors track particular problem engagements and "bad actors," but they can know where the most "agreeable and client-friendly" partners rotate to.

"You see some firms ... move certain partners around to big engagements, and I think it's important for investors to know that," Peters says.

"Institutional investors know this is out there, and they are looking at names," she says. "Proxy advisory firms and data providers will soon get more attuned to identifying the partners and track records."

Indeed, investors have begun to scrutinize auditor ratification more closely. Although the average support for auditor ratification at U.S. public companies so far this year has been around 98%, 18 companies have received less than 75% support on auditor ratification votes, according to **Audit Analytics**. This is slightly higher than the annual average for the period, between Jan. 1, 2016, and Dec. 31, 2018, when 32 companies received more than 25% against votes, according to Audit Analytics.

### **Audit Quality**

However, some audit committee members question whether the disclosure rule has added much to the process.

Indeed, **Eileen Kamerick**, director at **Associated Banc-Corp** and audit committee chair at **Hochschild Mining plc**, writes in an e-mail that this new rule does not change the level of responsibility the engagement partner and the firm already have.

Moreover, she says, the rule implies that only one engagement partner participated in the audit, which is not true. Kamerick writes that each firm already has “an elaborate and rigorous set of quality controls in order to ensure that the audit firm can support and defend the findings of its audit team.”

Although these controls are not failproof, disclosing the engagement partner’s name does not meaningfully increase protection for investors, she writes.

“[A]udit partners are very much aware of their personal and professional liability and responsibility for the audits they perform,” Kamerick writes. “They are also acutely aware of the liability and responsibility of their respective firms.”

Similarly, Cunningham recalls a Big Four partner discussing the new rule at a conference who stated that he didn’t think it would change how he did the audit.

“[But], he said, ‘When I sign the [firm’s] name, my hand is almost shaking. I already have to take that seriously,’” Cunningham says.

**Bob Herz**, audit committee chair at **Fannie Mae** and former chairman of the **Financial Accounting Standards Board** (FASB), says he thinks that in general, audit quality has improved “significantly” in recent years, but he attributes this to reforms stemming from the Sarbanes-Oxley Act and PCAOB inspections. In fact, he says engagement partners who work on an audit that is deficient in the PCAOB’s eyes are already known to have scarlet letters in the industry.

Meanwhile, audit committees themselves are voluntarily disclosing more information about audit firm evaluations, giving more accountability to their role in audit quality.

For example, 55% of S&P 100 companies disclosed in proxies this year why the audit committee decided to reappoint their independent auditor, up from 48% last year, according to **Deloitte**.

“Audit committees should be thinking about what information investors need, and maybe they should push to get that information out there first instead of waiting for the PCAOB to tell them,” Cunningham says.

“Audit committees should be asking themselves what they can be doing to give investors the transparency they are craving.”

*Editor's note:*

*This article previously indicated that a source said she was told by an investor that it voted against General Electric's auditor ratification after noting the recurrence of an audit partner over multiple years. A KPMG representative raised objection to the inclusion of this claim. We have not been able to independently verify the vote or year in which it is alleged to have occurred and have removed the text.*