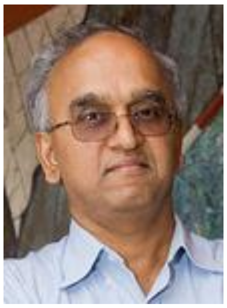
Study Backs Shareholder Ratification of Audit Firms



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By Michael Cohn, Accounting Today

A new academic study finds that when public companies give their shareholders a vote on the selection of an external auditing firm, they are less likely to make financial restatements than those that don't.

Kannan Raghunandan

The study, which appears in the latest issue of *The Accounting Review*, published by the American Accounting Association, found that only 5.1 percent of companies that give shareholders a say in auditor selection have to restate their results, compared to 8.1 percent who don't allow a shareholder vote. The difference is even more dramatic—3.5 percent compared to 6.1 percent—for restatements that are serious enough to lower the price of the company's stock, as measured by the five-day cumulative abnormal return surrounding the restatement announcement date.

Firms that forego shareholder ratification are nearly 75 percent more likely than others to have to issue restatements serious enough to have a negative effect on their stock price.

"Most companies have been assuming for a long time that shareholder ratification is a good thing, and in this case the companies have now been proved right," said Kannan Raghunandan, an accounting professor at Florida International University, who carried out the study with an FIU colleague, Dasartha V. Rama, and Mai Dao of the University of Toledo. "The oddity is that over the course of all these decades no one ever thought of actually testing whether getting the stockholders involved makes a difference. Well, clearly it does, and, perhaps our findings will help motivate less wavering by regulators on this issue."

Yet a number of companies are taking aggressive steps to thwart input from shareholders, lobbying the Securities and Exchange Commission to water down the "say on pay" rules on executive compensation in the Dodd-Frank Wall Street Reform and Consumer Protection Act. They are taking similar steps to prevent shareholders from getting a say on audit firm rotation, one of the proposals in a recent concept release from the Public Company Accounting Oversight Board.

In late December, the SEC granted General Electric and Alcoa permission to exclude from their 2012 annual meetings a shareholder proposal they opposed, calling for rotation of the companies' external auditors. Some weeks earlier the SEC did the same for Hewlett-Packard, Walt Disney, and John Deere and early in the New Year for AT&T, General Dynamics and others, all on the grounds that such proposals run counter to a decades-old rule excluding from proxy materials proposals that will affect firms' "ordinary business."

These episodes constitute the latest chapter of a longstanding controversy surrounding what is generally a thoroughly routine aspect of corporate governance—stockholder ratification of firms' choice of external auditors.

Companies have been inviting investors to weigh in on the question since the 1930s, and the vast majority of companies continue to do so today, the study pointed out, yet a shareholders' right to have a say on auditor selection has remained uncertain, despite the recommendation in 2008 by a blue-ribbon Treasury commission that annual shareholder ratification be mandatory.

The new study found, however, that the higher quality of the audits in companies that give shareholders a say in auditor choice also comes at a price, with those firms paying about 9 percent more on average than other companies. Since the median cost of an external audit among firms included in the study was about $1.5 million, on average this amounts to a difference of about $135,000. Companies that submit auditor selection for shareholder ratification tend to be larger than those that do not; are more likely to be audited by a Big Four firm; and are less likely to change auditors.

Audit firms that have the backing of shareholders also tend to have more leverage in discussions with management. "Shareholder involvement in auditor selection strengthens the power of the auditor in any negotiations with management and increases the 'pressure to perform' on the auditor,'" the study concluded. "If there is a shareholder vote, then questions will be raised if an auditor who routinely gets 98 percent ratification drops down to 95 or 90 percent support from shareholders."

To prevent such a possibility, however remote, of a negative vote, "it is likely that auditors would spend extra effort and be more cautious in negotiations with the client."

The professors drew their findings from an analysis of 1,382 companies included in a major corporate database for 2006, a year early enough to allow ample time for subsequent restatements of financial results. They found that 1,036 companies, or approximately three-quarters of the total, had shareholder ratification of auditor choice. In all, 81 of the companies issued financial restatements, 57 of which were serious enough to negatively affect their stock price.