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# Increased Audit Competition Leads to Opinion Shopping

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BY MICHAEL COHN

Mandatory rotation of auditing firms could lead to more "opinion shopping" by companies looking for clean opinions on their internal controls, a new study suggests.

Michael Wilkins

The European Union is preparing to impose a new rule that takes effect in June requiring public companies to rotate their auditing firms. In the U.S., the Public Company Accounting Oversight Board issued a concept release proposing mandatory audit firm rotation in 2011 but backed away from the proposal after the House of Representatives voted in 2013 to prohibit such a requirement.

The assumption by some regulators has been that, by upsetting long-term cozy relationships between audits and their corporate clients and introducing more competition for the clients' auditing business, the rule would improve corporate financial reporting. But some new research finds that in at least one important way competition undermines that goal and appears to compromise auditor independence.

A study in the **American Accounting Association** journal ***The Accounting Review*** finds that competition for audit clients fosters opinion shopping with respect to internal controls, the systems that firms establish to assure that financial statements are reliable and accord with GAAP. Under the Sarbanes-Oxley Act of 2002, companies and their auditors are required not

only to make the traditional annual certification of overall accounting quality but also to vouch for the effectiveness of internal controls.

The new research, which, the authors say, is "the first to document the existence of opinion-shopping in any form in the post-SOX era," concludes that shopping for favorable auditor opinions on internal controls" is most pervasive when [auditor] competition is relatively high...suggesting that increased competition in audit markets may actually impact audit quality negatively." In the aftermath of SOX, the study finds, internal controls, which once were a non-factor in opinion-shopping, have become a major factor.

"While it may seem natural for companies to shop for favorable audit opinions and switch auditors to get them, a number of studies have concluded switching is futile, citing evidence that, on average, opinions are no more favorable post-switch than they were pre-switch," said Michael S. Wilkins of Trinity University, a co-author of the new paper. "This evidence notwithstanding, what our findings suggest is that clients would receive adverse internal-control opinions even more frequently without opinion-shopping. Note that opinion-shopping doesn't necessarily mean changing auditors; it can also drive a decision not to switch. In short, our findings suggest that opinion shopping pays; that concern over internal controls has become a major factor in motivating it; that companies engage in it to a significant degree; and that competition among auditors increases its prevalence."

Wilkins collaborated on the research Julie S. Persellin of Trinity University, Nathan J. Newton of the University of Missouri, and Dechun Wang of Texas A&M University.

The researchers also found evidence that auditor dismissals late in a company's fiscal year are a sign of company trouble. "Auditor dismissals that occur relatively late in the reporting period are much more likely to be associated with opinion-shopping than auditor dismissals [in the first and second quarters], particularly when audit markets are competitive," said the study. This is likely to be the case, the researchers found, when companies switch from one of the Big Four auditors to a mid-tier or smaller firm. Thus, "54% of the late switchers in our sample change to mid-tier or smaller auditors, compared to only 33% of early switchers. To the extent that late dismissals are more likely to be associated with opinion-shopping activities, a relationship between opinion shopping and auditor quality appears to exist in [those] dismissal situations."

The paper's findings are based on seven years' worth of financial, market, and audit information (2005 through 2011) drawn from large corporate databases, an aggregation of data covering 11,846 firm-years. The professors conducted an analysis in two stages. First they examined auditors' reports of material weakness in internal controls (the most adverse internal-control opinion that can be reached) in companies' current and prior year. Controlling for more than 20 factors that might contribute to a material weakness verdict (for example, whether the company has to restate earnings or suffers a net loss or is at risk for bankruptcy or has relatively low institutional ownership), they found that, in general, chances of a material weakness opinion

diminished if a company dismissed its auditor and, unsurprisingly, this was especially true if that auditor had issued a material weakness opinion the previous year.

Based on the correlations uncovered in this first stage of analysis, the researchers investigated whether decisions to retain or dismiss auditors might reflect shopping for a favorable opinion on internal controls. They found that decisions did so to a significant degree, with a less than 5 percent chance the relationship was mere coincidence.

The researchers then probed how this opinion shopping might be related to the amount of competition among auditing firms and found its prevalence to increase with the amount of competition in a market.

“The findings are consistent with a previous paper by our group which shows an increasing likelihood of financial restatements in markets with high competition,” said Wilkins. “The implication of both papers is that, when audit firms are subject to greater competition, audit quality suffers."

Wilkins pointed to a 2015 *Accounting Review* study by other investigators that indicated a pattern of avoidance among a large sample of companies in reporting internal-control weaknesses. "Our study suggests a likely mechanism for at least some of that avoidance – namely, opinion shopping," he said.

He observed that evaluating internal controls poses considerable challenges to auditor independence.

"Before SOX, clients engaged in opinion shopping either to get auditors to buy off on aggressive accounting or to avoid going-concern opinions that cast doubt on a firm’s basic financial viability, opinions that were rarely issued,” said Wilkins. “With SOX’s introduction of internal-control reporting, there is an additional, major reason to shop for opinions, and the practice is probably more widespread than ever before. And, given the large element of judgment, the grey area, in opinions about internal controls, it is not surprising that some regulators have expressed concern that deficiencies which should be labeled material weaknesses are instead classified as significant deficiencies, which require no external reporting. In any event, our study strongly suggests that competition serves to increase opinion shopping with respect to an essential element in financial reporting. Most of the discussion of opinion shopping since SOX has occurred in connection with the issue of mandatory auditor rotation, so our findings should certainly give pause to those who view increased competition as necessarily a favorable outcome of such a requirement.”