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Auditor Ratification: Can't Get No (Dis)Satisfaction

Lauren M. Cunningham
The University of Tennessee

SYNOPSIS: The auditor ratification vote provides shareholders with an opportunity to voice their opinions about the company's choice of auditor, but, historically, less than 2 percent of shareholders express dissent in their vote. Motivated by regulatory attention on the importance of shareholder involvement and the institutional power of proxy advisors on voting outcomes, I examine the proxy advisor's role in the auditor ratification vote. I find that proxy advisors have a statistically significant influence over shareholder voting outcomes when they recommend against auditor ratification, but the *Against* recommendation is rare, and the qualitative significance is less clear. Proxy advisor *Against* recommendations are based on concerns about auditor independence and poor audit quality, but there appears to be variation in the extent to which proxy advisors issue *Against* recommendations for each of these criteria. I discuss the implications of the findings, which should be of interest to regulators, investors, public companies, and audit firms.

Keywords: auditor ratification; corporate governance; proxy advisor; proxy disclosure; shareholder voting.

INTRODUCTION

In this paper, I examine the impact of proxy advisor recommendations in the auditor ratification vote and the factors used by proxy advisors in making their recommendations. I also provide insight into why there are not more proxy advisor recommendations against the auditor. More than 90 percent of Russell 3000 companies voluntarily ask shareholders to ratify the company's choice of auditor ("auditor ratification") as a matter of "good corporate governance."[1] As demonstrated by a recent campaign to vote against Bank of America's auditors following a material restatement, the effectiveness of this vote is still a matter of debate (Thomas 2014):

> If shareholders vote against auditor ratification, does anyone care? That's the question many investor groups were asking themselves following the ratification of Bank of America's external auditor PwC at the company's annual meeting on May 7. Just 10 days prior, the bank disclosed in a filing that it made a significant accounting error in the past, reporting that it had $4 billion more in capital than it actually had. Onlookers wondered just how a mistake of that magnitude could slip past PwC . . . But *despite public campaigns against the ratification of the audit firm . . . Bank of America received approximately 93% of votes in favor of retaining PwC as auditor*. (emphasis added)

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This paper is based on my dissertation at the University of Arkansas under the name Lauren M. Dreher and was previously titled "Proxy Advisor Recommendations on Auditor Ratification: Who is Listening?"

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[1] As disclosed in Walmart's DEF 14A, filed on April 22, 2013 (page 39; emphasis added), "Although shareholder ratification is not required, the appointment of E&Y as the company's independent accountants for fiscal 2014 is being submitted for ratification at the 2013 Annual Shareholders' Meeting because *the Board believes doing so is a good corporate governance practice*." I use "shareholder ratification of the auditor" and "auditor ratification" synonymously.

Proxy advisors conduct independent research and provide summarized voting recommendations, *For* or *Against,* that assist shareholders in synthesizing information and making effective voting decisions.[2] Proxy advisors are engaged by, and paid by, subscribing shareholders. Their primary customers are institutional investors, such as asset managers, mutual funds, and pension funds, who would otherwise incur significant costs to conduct in-house analyses for all companies in their investment portfolios (Government Accountability Office [GAO] 2007). For example, "U.S. issuers pose more than 250,000 proxy questions a year, and it is not unusual for large mutual funds and their advisers to be required to cast votes on more than 100,000 of them on the basis of actively developed voting policies" (Glassman and Verret 2013, 10).

Understanding the influence of proxy advisors in auditor ratification is important because previous literature has found that proxy advisors have a significant influence on shareholder voting in other settings, such as director elections, executive compensation, and non-routine proposals (Bethel and Gillan 2002; Cai, Garner, and Walkling 2009; Ertimur, Ferri, and Oesch 2013; Larcker, McCall, and Ormazabal 2015). In these other management and shareholder proposals, average dissenting votes are up to 14 percent,[3] and a proxy advisor *Against* recommendation can increase the percentage of dissenting votes by 13 to 25 percentage points (Bethel and Gillan 2002; Cai et al. 2009; Ertimur et al. 2013; Larcker et al. 2015).[4]

I begin by examining the association between proxy advisor *Against* recommendations and dissenting shareholder votes, to demonstrate whether shareholders are affected by proxy advisor recommendations in the auditor ratification setting. Prior literature on auditor ratification has examined the determinants of shareholder voting without examining the influence of proxy advisors (Glezen and Millar 1985; Sainty, Taylor, and Williams 2002; Raghunandan 2003; Raghunandan and Rama 2003; Mishra, Raghunandan, and Rama 2005; Dao, Mishra, and Raghunandan 2008; Hermanson, Krishnan, and Ye 2009; Liu, Raghunandan, and Rama 2009). After controlling for these determinants, I find that the proxy advisor recommendation has a significant effect on shareholder voting, with an increase of approximately 6.7 percentage points in dissenting votes. My analyses use recommendations from the top two proxy advisory firms, Glass, Lewis & Co., LLC (Glass Lewis) and Institutional Shareholder Services, Inc. (ISS), for Russell 3000 companies from 2009 through 2012. Proxy advisor influence varies with the type of ownership and is greater for companies with higher nonaudit services, longer auditor tenure, stronger corporate governance, and higher levels of dissatisfaction toward the company in general.

Next, I examine the determinants of proxy advisor recommendations on auditor ratification. Less than 3 percent of observations receive an *Against* recommendation. I use the detailed guidelines published by Glass Lewis and ISS, which include publicly available signals that would be associated with poor audit quality or concerns about auditor independence. This allows me to observe which factors or guidelines the proxy advisor weighs more (or less) heavily. Multivariate analysis suggests that proxy advisors are more likely to issue an *Against* recommendation based on concerns about auditor independence and concerns about poor audit quality.

Finally, to provide insight into why there are not more proxy advisor recommendations against the auditor, I use the significant factors from the analysis above to identify the number of observations that would be suspected of receiving an *Against* recommendation, and I calculate the percentage of observations that do, in fact, receive an *Against* recommendation. In contrast to the multivariate analysis above, which allows me to examine, *on average,* which criteria are more or less important to proxy advisors, this alternative approach allows me to examine *how often* proxy advisors do not issue an *Against* recommendation to a "suspect" observation. Here, I find that a high percentage of suspect observations receive an *Against* recommendation for excessive nonaudit services (69 percent) and legal limitations disclosed in the DEF 14A filing (85 percent). Alternatively, proxy advisors issue a much smaller percentage of *Against* recommendations based on the audit quality criteria disclosed in their guidelines; specifically, material restatements (12 percent) and aggressive accounting policies, proxied for by high absolute value of discretionary accruals (4 percent). This suggests that additional attention by proxy advisors around proxies for poor audit quality may result in a substantial increase to the rate of *Against* recommendations. In multivariate analyses, I find that among observations suspected of receiving an *Against* recommendation, proxy advisors are less likely to actually issue an *Against* recommendation to companies with stronger returns and companies willing to admit that there are material weaknesses in internal control disclosures. However, they are more likely to issue an *Against* recommendation when the auditor-client tenure is longer or when the auditor is a Big 4 firm.

[2] As described further at: http://www.issgovernance.com/policy-gateway/policy-outreach/, proxy advisors regularly solicit feedback on their policy recommendations from "institutional investors, corporate issuers, corporate directors and other governance market constituents."

[3] For compensation-related management and shareholder proposals, Bethel and Gillan (2002) report average dissent of up to 14 percent. Regarding say on pay, Ertimur et al. (2013) report average dissent of 10 percent. Finally, in director elections, average dissent is 5 to 6 percent (Cai et al. 2009; Choi et al. 2010).

[4] Using a large sample of company and shareholder proposals (not related to auditor ratification), Bethel and Gillan (2002) find that an *Against* recommendation is associated with a 13.6 to 20.6 percentage point decrease in favorable votes cast, depending on the proposal type. Cai et al. (2009) find that an *Against* recommendation on uncontested director elections is associated with a 19 percentage point decrease in votes cast in favor of the director's election. Ertimur et al. (2013) and Larcker et al. (2015) find that an *Against* recommendation on say on pay is associated with a 13 to 25 percentage point decrease in favorable votes.

The results contribute to the literatures on auditor selection, shareholder voting, and the influence of proxy advisors in several ways. First, while the statistically significant association between proxy advisor recommendations and shareholder voting for auditor ratification may not be surprising *per se,* my findings suggest that there is variation in the extent to which shareholders react to proxy advisor recommendations. The reaction in my study appears substantially lower than prior literature examining proxy advisor recommendations in other settings. Second, I show that there is variation in the extent to which proxy advisors follow their own guidelines. Part of this variation can be explained by company characteristics, such as performance, willingness to disclose material weaknesses, auditor tenure, and auditor size. In the concluding section, I provide additional commentary on why the variation might exist, particularly as it relates to audit quality measures.

BACKGROUND

Shareholder Ratification of the Auditor

Early drafts of the Investment Company Act of 1940 included a provision for mandatory shareholder ratification of the auditor. This provision was designed to reinforce the fact that auditors should be acting on behalf of shareholders and not management (Brown 2012). Although the final 1940 rule did not include this provision, the Sarbanes-Oxley Act of 2002 (SOX) introduced a requirement designed to achieve similar goals (Securities and Exchange Commission [SEC] 2003a, 2003b). Specifically, SOX Section 301 transferred legal oversight of the auditor, including hiring and firing decisions, to the newly mandated, fully independent audit committee. Unfortunately, post-SOX surveys of audit managers and partners suggest that Section 301 has not been effective in taking hiring and firing decisions away from management. Auditors still believe that the company's management has the greatest influence on auditor hiring and firing decisions (KPMG 2004; Cohen, Krishnamoorthy, and Wright 2010).[5]

In 2008, the Advisory Committee on the Auditing Profession (ACAP) to the U.S. Department of the Treasury recommended that shareholder ratification of the auditor be mandated (ACAP 2008). While the intention of ACAP (2008) was focused on increased audit firm competition, experimental results from Mayhew and Pike (2004) and archival results from Dao, Raghunandan, and Rama (2012) suggest that shareholder involvement in auditor ratification improves audit quality. While no changes to the shareholder voting requirements have been made to date, ACAP (2008) reports that 95 percent of Standard & Poor's (S&P) 500 companies and 70 to 80 percent of smaller companies include auditor ratification on the ballot in 2006. In my sample of Russell 3000 companies for 2009 through 2012, I find (untabulated) that more than 90 percent of companies voluntarily include auditor ratification on the ballot.

Shareholders have three choices when making their vote on the auditor ratification ballot item: vote *For* the auditor, vote *Against* the auditor, or *Abstain* from voting. Prior literature has identified several determinants of the auditor ratification vote (Glezen and Millar 1985; Sainty et al. 2002; Raghunandan 2003; Raghunandan and Rama 2003; Mishra et al. 2005; Dao et al. 2008; Hermanson et al. 2009; Liu et al. 2009). Specific to auditor characteristics, these studies find that the percentage of votes cast against auditor ratification is higher when (1) there are concerns about auditor independence, proxied for by a higher percentage of nonaudit fees to total fees and longer auditor tenure, and (2) there are concerns about financial reporting quality, proxied for by restatements or material weaknesses. These studies identify a number of factors that may be associated with general dissatisfaction toward the company that is not auditor-specific, such as lower returns, lower profitability, lower-quality corporate governance, as proxied for by the combination of the CEO and Chairman positions, and a higher percentage of votes cast against director elections. These studies also find that the type of shareholder base affects the voting outcome in general because the percentage of votes cast against a ballot item is typically higher when there is lower insider ownership or blockholder ownership. Findings are mixed for the presence of Big N auditors and the percentage of institutional ownership.

Proxy Advisors

Proxy advisory services are dominated by two main suppliers: ISS and Glass Lewis (GAO 2007). Proxy advisors' policy recommendations are formed using interaction with institutional investors and public companies. For example, as stated on ISS's website:

[5] In response to the question "who *actually* has the most *influence* in the appointment and dismissal of auditors in a public company," audit partners and managers in the 2006 survey assigned a mean percentage influence of 53 percent to management, 41 percent to the audit committee, 5 percent to the board of directors, and 1 percent to stockholders (Cohen et al. 2010, 763; emphasis in the original). One respondent replied, "I would say without a doubt, management. Clearly the law stipulates that it is the responsibility of the audit committee. We acknowledge that readily in our engagement letters so that it's clear from a contractual standpoint that we understand that and presumably the audit committee understands that but I would say point of fact that the group of individuals who hold the most influence over the appointment decision and retention would be management" (Cohen et al. 2010, 763).

> ISS kicked off its annual global policy formulation process in July 2015 by inviting institutional investors, corporate issuers, corporate directors and various other governance market constituents to participate in its 2016 proxy voting policy survey . . . After analysis and consideration of the survey responses, ISS will later open a comment period for all interested market participants on the final proposed changes to our policies for 2016.[6]

The demand for proxy advisors was heightened after an SEC (2003c) ruling that required investment advisors to establish and disclose voting policies when voting uninstructed shares, i.e., shares held on behalf of clients that do not provide voting instructions. Because conflicts of interest may arise between investment advisors and the companies held by their clients, the SEC ruling suggested that the investment advisor vote uninstructed shares "based upon the *recommendations of an independent third party*" (SEC 2003c, II.A.2.b; emphasis added). Thus, an unintended consequence of the ruling was a surge in the demand for guidance from proxy advisors.[7] In 2010, 19 percent of corporate directors surveyed believed that proxy advisors held the *most* influence over the board (PricewaterhouseCoopers [PwC] 2010), and a corporate governance consulting firm estimated that clients of proxy advisors controlled 25 to 40 percent of votes cast at an annual meeting, placing proxy advisors in a position to yield significant influence over voting outcomes.[8]

RESEARCH DESIGN

My analysis is divided into three components. First, I examine the impact of proxy advisor recommendations in the auditor ratification vote. Second, I examine the factors used by proxy advisors in making their recommendations. Finally, I provide insight into why there are not more proxy advisor recommendations against the auditor.

Data

Using the ISS Voting Analytics database and data provided by Glass Lewis, I collect proxy advisor recommendations and shareholder voting outcomes for all companies in the Russell 3000 index with an auditor ratification vote for annual meeting dates between January 1, 2009 and June 30, 2012.[9] I limit my analysis of proxy advisor recommendations to ISS and Glass Lewis because Choi, Fisch, and Kahan (2010) find that ISS is the most powerful proxy advisor and, among the others, only Glass Lewis has a significant influence on voting outcomes.[10] Each observation in my sample is one company meeting date. The meeting date typically occurs three to six months following the fiscal year-end. Unless otherwise noted, auditor and company characteristics are measured using the 10-K filing immediately preceding the meeting date, as collected by Compustat and Audit Analytics. Audit fee and governance information is measured using the DEF 14A immediately preceding the meeting date, as collected by Audit Analytics and Corporate Library. I use Thomson Reuters 13F database to obtain institutional holdings, and I use CRSP to obtain market return information.

Table 1 provides the sample selection process. I begin with 10,603 company-meeting observations with both Glass Lewis and ISS recommendations for auditor ratification. I remove 213 observations without final vote data and 67 observations without matching identifiers from Audit Analytics, Compustat, CRSP, or Corporate Library databases. To ensure that measurements for auditor characteristics align with the auditor subject to ratification, I remove 222 observations where auditor turnover is announced between the fiscal year-end and the meeting date, or where the auditor designated on the ballot is not the same as the auditor of record as of year-end, which I identify using the Corporate Library database. This ensures that proxy advisor and shareholder reactions are based on the information relevant to the auditor of record in the prior year. I remove 1,098 observations with insufficient data to calculate the variables in Equations (1) and (2). The resulting sample includes 9,003 observations.

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[6] Available at: http://www.issgovernance.com/policy-gateway/policy-outreach (last accessed on December 15, 2015).

[7] For a more detailed account of the influence of this regulation and two 2004 SEC no-action letters on the demand for proxy advisory services, see Glassman and Verret (2013).

[8] Based on a presentation to the American Bar Association Corporate Governance Committee meeting on October 12, 2010 by Innisfree M&A Incorporated (available at: http://apps.americanbar.org/buslaw/committees/CL260000pub/materials/20101012/TrendsShareholderVoting.pdf [last accessed April 3, 2013]).

[9] My sample is restricted to these dates based on data that were provided by Glass Lewis. My sample is restricted to the Russell 3000 companies because the ISS Voting Analytics database, which I also use for calculating shareholder voting outcomes, only includes the Russell 3000 companies. ISS's actual coverage includes nearly every company with a shareholder vote.

[10] In addition to Glass Lewis and ISS, there are three other proxy advisors available to subscribers: Egan-Jones Proxy Services, Marco Consulting Group, and C&W Investment Group. The GAO (2007) estimates that ISS's clients' equity dollars is approximately 25.5 trillion, Glass Lewis' is approximately 15 trillion, and the remaining advisors are 1 trillion or less.

TABLE 1

Sample Selection

Observations in the Russell 3000 with Glass Lewis and ISS recommendations on auditor ratification with meeting dates between January 1, 2009 and June 30, 2012	10,603
Less: observations without final vote data	(213)
Less: observations missing Audit Analytics, Compustat, CRSP, or Corporate Library identifiers	(67)
Less: observations where auditor turnover is announced between the fiscal year-end and the annual meeting date, or where the auditor being elected is not the same auditor as for the prior fiscal year-end	(222)
Less: observations with insufficient data to calculate independent variables in Equations (1) and (2)	(1,098)
Final Sample	9,003

Proxy Advisor Recommendations on Auditor Ratification and Shareholder Voting

To determine whether proxy advisor recommendations affect shareholder ratification of the auditor, I follow the proxy advisor literature from other voting settings (Bethel and Gillan 2002; Cai et al. 2009; Ertimur et al. 2013; Larcker et al. 2015) and regress the percentage of dissenting votes on my variable of interest, *RecAgainst*. I set *RecAgainst* equal to 1 when the company receives an *Against* recommendation specific to auditor ratification, and 0 otherwise. Because I expect that an *Against* recommendation is associated with a higher percentage of dissenting shareholder votes, I expect a positive coefficient on *RecAgainst*. The model is as follows:

$$\begin{aligned} VoteAgainst_{it} = {} & \beta_0 + \beta_1 RecAgainst_{it} + \beta_2 lnAssets_{it} + \beta_3 Returns_{it} + \beta_4 NAS_{it} + \beta_5 lnAudTenure_{it} + \beta_6 MWeak_{it} \\ & + \beta_7 Restate_{it} + \beta_8 Blockholders_{it} + \beta_9 CEO\_Chair_{it} + \beta_{10} DirVote_{it} + \beta_{11} Big4_{it} + \beta_{12} Inst_{it} + \beta_j Year\ FE \\ & + \varepsilon_{it} \end{aligned} \tag{1}$$

I use the definition of *VoteAgainst* provided by Sainty et al. (2002): the number of shares voting against or abstaining from auditor ratification, divided by the number of non-insider voting shares.[11] I use control variables from the prior literature on auditor ratification (Glezen and Millar 1985; Sainty et al. 2002; Raghunandan 2003; Raghunandan and Rama 2003; Mishra et al. 2005; Dao et al. 2008; Hermanson et al. 2009; Liu et al. 2009). All variables are as defined in Appendix B. I estimate Equation (1) using ordinary least squares (OLS) regression and estimate robust standard errors that are clustered by company identifier. Continuous variables, other than the dependent variable *VoteAgainst* and the corresponding *DirVote,* are winsorized by year at the 1 percent and 99 percent levels. *VoteAgainst* and *DirVote* are not winsorized because they are highly skewed and winsorization would eliminate material variation in the variables at the 99 percent level.[12]

To identify where proxy advisors have a stronger influence over voting decisions, I then reestimate Equation (1) where I interact *RecAgainst* with each of the control variables to determine whether shareholders react differently to publicly available signals about auditor independence, audit quality, and company characteristics in the presence of a proxy advisor recommendation.

Factors Affecting Proxy Advisor Recommendations

Because current DEF 14A disclosure requirements require relatively little information about the audit committee's process for appointing or retaining a specific audit firm subject to vote (SEC 2015), proxy advisors are left to rely on publicly available cues about auditor independence and audit quality. Based on their published guidelines (reported in Appendix A) they consider: (1) indicators of a breach in independence, such as excessive nonaudit services and legal limitations between the company and

[11] Following prior literature, I also consider alternative measures of *VoteAgainst* using: (1) the percentage of total votes cast against, or (2) the percentage of total votes cast against or abstaining, with a control variable for the percentage of insider shares held. Because the vote variables are highly skewed, I also consider transformed versions of *VoteAgainst* for the log transformation (Hermanson et al. 2009) and the arcsine of the square root (Ye, Hermanson, and Krishnan 2013), and also an indicator variable for whether *VoteAgainst* exceeds 5 percent. This yields a total of 11 alternative measures of *VoteAgainst*. For all 11 alternative measures, I continue to find (untabulated) that *RecAgainst* remains positive and significant (p-value = 0.000) in Equation (1).

[12] If I winsorize *VoteAgainst,* then the maximum (minimum) value is 0.141 (0.000), compared to the unwinsorized maximum (minimum) value of 0.614 (0.000) reported in Table 2, and I continue to find (untabulated) that *RecAgainst* remains positive and significant (p-value = 0.000) in Equation (1).

the auditor, and (2) indicators of poor audit quality using terms such as "restatements," "material weaknesses," "late filings," "aggressive accounting policies," "poor disclosure or lack of transparency," and "excessively low" audit fees.

Given the publicly available criteria published by proxy advisors, it may seem counterintuitive to empirically examine the factors affecting proxy advisor recommendations. However, this analysis allows me to examine (1) whether proxy advisors issue *Against* recommendations consistent with their guidelines, and (2) which factors are weighted more or less heavily in the final recommendation. Proxy advisors may weight information differently if they believe that shareholders value certain information more or less heavily. Additionally, there are different processing costs to incorporating information, since the information used to develop the recommendation is largely dispersed and not centralized during the voting process. For example, while audit fees and legal limitations are centrally reported in the DEF 14A filing, audit quality information may be collected from 8-K, 10-K, or 10-Q filings.

I estimate the following equation for the full sample to determine which factors affect proxy advisor recommendations for auditor ratification:

$$RecAgainst_{it} = \beta_0 + \beta_1 ExcessNAS_{it} + \beta_2 LegalLanguage_{it} + \beta_3 Restate_{it} + \beta_4 HighAbsDA_{it} + \beta_5 SEC\_CmtLtr_{it} + \beta_6 LowAuditFees_{it} + \beta_j Year\ FE + \varepsilon_{it} \quad (2)$$

All variables are as defined in Appendix B and described further below. I estimate Equation (2) using logistic regression and estimate robust standard errors that are clustered by company identifier.

Indicators of a Breach in Independence

In proxying for potential breaches in independence based on performance of excessive nonaudit services, I use the definition provided by Glass Lewis because there are only two observations meeting the stricter ISS criteria. I set *ExcessNAS* equal to 1 when tax and other fees are greater than audit fees and audit-related fees, and 0 otherwise.

The criterion for legal limitations between the company and the auditor focuses on clauses in the audit engagement letter such as the requirement to settle disputes using arbitration or alternative dispute resolution (ADR) or limitation of liability for punitive damages. It is specific to disputes between the company and the auditor, and does not affect shareholder litigation against the auditor. For example, as stated in IHS Inc.'s 2011 DEF 14A filing, "[i]n connection with the audit of the 2010 financial statements, IHS entered into an engagement agreement with Ernst & Young LLP that . . . subjects IHS to alternative dispute resolution procedures and excludes the award of punitive damages in the event of a dispute between IHS and Ernst & Young LLP."[13] Proxy advisors obtain this information based on publicly available disclosures in the DEF 14A proxy statement filings.

Proxy advisors include this in their consideration due to attention given by regulators in considering how these clauses affect auditor independence. See Public Company Accounting Oversight Board (PCAOB 2006) for a discussion of concerns raised by both the SEC and the PCAOB. Despite these concerns, this remains a fairly standard practice in public accounting firm engagement letters and, thus, this criterion used by proxy advisors may inadvertently penalize companies that choose to voluntarily disclose the arrangement. Discussions with partners from each of the Big 4 and two other major accounting firms indicate that for five of the six firms questioned, ADR clauses are fairly standard in their engagement letters. There are exceptions where the ADR language is not part of the engagement letter, but that would require special approval. Further, my discussions with a CFO and Assistant General Counsel of a Fortune 100 company suggest that they advocate for these legal clauses to keep litigation costs low between the company and the auditor, should litigation arise.

Because this is not a mandatory disclosure, only some companies choose to disclose these arrangements. I use a keyword search to extract all DEF 14A filings where the words "alternative dispute resolution," "arbitration," or "punitive" are present. For those in my sample, I read all auditor-related disclosures in the DEF 14A filing and determine whether engagement letter legal limitations are disclosed. I set *LegalLanguage* equal to 1 when legal limitations are disclosed, and 0 otherwise.

Indicators of Poor Audit Quality

Following the Glass Lewis and ISS criteria, I proxy for poor audit quality using a number of variables. First, for restatements, I use an indicator variable, *Restate,* set equal to 1 if the company issues a restatement in the year preceding the meeting date, and 0 otherwise. I use the Audit Analytics Non-Reliance database and require that the auditor being voted on is the auditor during the misstatement period. Second, I proxy for "aggressive accounting policies" using an indicator variable, *HighAbsDA,* set equal to 1 when the observation is in the top two-digit industry-year decile of the absolute value of

[13] See page 6 of the DEF 14A filing filed on March 23, 2011; available at: http://www.sec.gov/Archives/edgar/data/1316360/000119312511075263/ddef14a.htm

performance-adjusted modified Jones model discretionary accruals, and 0 otherwise. Third, I proxy for "poor disclosure or lack of transparency" using the receipt of an SEC comment letter because comment letters provide "independent and timely feedback on the clarity of disclosures and on the extent to which filings comply with Generally Accepted Accounting Principles and SEC reporting regulations" (Cassell, Dreher, and Myers 2013, 1875). *SEC_CmtLtr* is an indicator variable set equal to 1 if the company receives a comment letter on a 10-K or 10-Q filing in the year preceding the meeting date, and 0 otherwise. Finally, I proxy for "excessively low" audit fees using an indicator variable, *LowAuditFees,* set equal to 1 if the observation is in the lowest industry-year decile of the ratio of audit fees to total assets, and 0 otherwise.[14]

Why are Proxy Advisor *Against* Recommendations in Auditor Ratification So Rare?

To complement the analysis above, I perform two additional analyses to provide insight into why there are so few proxy advisor recommendations. First, I use the statistically significant criteria described above to identify "suspect" observations, i.e., when one of the variables above is equal to 1. I then calculate the percentage of "actual" *Against* recommendations for each group of suspect observations. Whereas Equation (2) provides results for, *on average,* what matters more or less, this additional univariate analysis allows me to examine the magnitude of potentially "missing" *Against* recommendations. Because proxy advisor criteria are simply guidelines and not strict rules, I do not necessarily expect 100 percent of a group of suspect observations to receive an *Against* recommendation. However, this analysis will provide additional insight into variation within the proxy advisor criteria.

Second, I investigate the company and auditor characteristics that may be used by proxy advisors when deciding whether to issue an *Against* recommendation to companies identified as "suspect." Here, I limit the sample to only those observations where one of the statistically significant suspect criteria described above is present. I then use multivariate analysis to determine other company or auditor characteristics that may affect the final decision to issue an *Against* recommendation. The model for the reduced sample of "suspect" observations only is as follows:

$$RecAgainst_{it} = \beta_0 + \beta_1 lnAssets_{it} + \beta_2 Returns_{it} + \beta_3 MWeak_{it} + \beta_4 lnAudTenure_{it} + \beta_5 Big4_{it} + \beta_6 Blockholders_{it} + \beta_7 Inst_{it} + \beta_8 CEO\_Chair_{it} + \beta_j Year\ FE + \varepsilon_{it} \quad (3)$$

All variables are as defined in Appendix B. I estimate Equation (3) using logistic regression and estimate robust standard errors that are clustered by company identifier.

The model includes company size (*lnAssets*), company performance (*Returns*), company internal control quality and the willingness of the company and/or the auditor to report the condition (*MWeak*), the length of the auditor-client relationship (*lnAudTenure*), the national reputation of the audit firm (*Big4*), the presence of large stakeholders (*Blockholders*) or institutional shareholders, which are the primary subscribers of proxy advisory services (*Inst*), and concerns about corporate governance proxied for by the duality of the CEO-Chairman (*CEO_Chair*). I do not include the variables in Equation (2) since the sample is only comprised of those observations where at least one of the significant variables in Equation (2) is set equal to 1. Additionally, no directional predictions are made since the intent of the model is to determine which factors may influence the proxy advisor's decision to issue (or not issue) an *Against* recommendation.[15]

RESULTS

Descriptive statistics are reported in Table 2. The average percentage of dissenting shareholders (*VoteAgainst*) is 1.9 percent of non-insider voting shares, with a minimum of 0.0 percent and a maximum of 61.4 percent. Approximately 2.6 percent of observations receive an *Against* recommendation on auditor ratification. The control variables are similar to those

[14] I use this simplified ratio based on conversations with a former employee of Glass Lewis and also to maximize data retention. Inferences (untabulated) remain the same if I use a reduced sample with an indicator variable set equal to 1 when the observation is in the lowest decile from the residual in an audit fee model, following Ettredge, Li, and Scholz (2007), estimated using ordinary least squares regression for all company-years between 2008 and 2012 with available Compustat and Audit Analytics data, and 0 otherwise. I also considered other criteria mentioned in the proxy advisor guidelines not listed above. Both Glass Lewis and ISS mention material weaknesses as a potential factor. Untabulated, I find that there is no significant difference in rates of material weaknesses between *Against* and *For* recommendation observations. The Glass Lewis criteria also include consideration for late filings. Following Impink, Lubberink, van Praag, and Veenman (2012), I use the Audit Analytics Non-Timely (NT) Filer Information and Analysis database to identify late filings. I classify late filings as having auditor responsibility if the category is either "6" (auditor unable to finish review or audit not complete), "14" (auditor in process of PCAOB registration), "48" (inability to pay auditors or dispute), or "55" (change in scope of audit), and not equal to "3" (change in auditor). Using the classifications provided by Audit Analytics, I identify only three instances in my sample where the auditor bears some responsibility for a late filing, so I do not include this variable in the model. Finally, the ISS criteria also include consideration for fraud. Because I identify fraud using the Audit Analytics Non-Reliance database, fraud is already captured within the *Restate* variable.

[15] I do not separately estimate this for each of the "suspect" criteria since the number of observations would be substantially lower if estimated separately.

TABLE 2

Descriptive Statistics
Equation (1)

	Mean	Std. Dev.	Min	25%	Median	75%	Max
VoteAgainst	0.019	0.030	0.000	0.005	0.012	0.022	0.614
RecAgainst	0.026	0.160	0.000	0.000	0.000	0.000	1.000
Assets	7,806	22,334	26	424	1,424	4,722	179,896
Returns	0.022	0.147	−0.329	−0.049	0.006	0.066	1.157
NAS	0.154	0.132	0.000	0.046	0.124	0.229	0.591
AudTenure	12.077	9.179	1.000	6.000	9.000	16.000	38.000
MWeak	0.022	0.146	0.000	0.000	0.000	0.000	1.000
Restate	0.036	0.185	0.000	0.000	0.000	0.000	1.000
Blockholders	0.253	0.166	0.000	0.130	0.230	0.353	0.786
CEO_Chair	0.469	0.499	0.000	0.000	0.000	1.000	1.000
DirVote	0.064	0.081	0.000	0.019	0.036	0.074	0.733
Big4	0.859	0.348	0.000	1.000	1.000	1.000	1.000
Inst	0.691	0.247	0.000	0.541	0.749	0.885	1.000

n = 9,003

Percentages are reported in decimal form (e.g., 0.005 represents 0.5 percent). *lnAudTenure* and *lnAssets* are presented as unlogged values for better interpretability.
All variables are as defined in Appendix B.

reported in prior studies on auditor ratification. Multicollinearity does not appear to be an issue in the sample, since variance inflation factors (VIFs) for all variables in Equations (1) and (2) are less than 2.0 (untabulated). As expected, the VIFs in the interacted version of Equation (1) are higher, with an average of 3.5.

Proxy Advisor Recommendations on Auditor Ratification and Shareholder Voting

As reported in Table 3, Panel A, the mean (median) percentage of dissenting votes is 8.6 (7.0) percent when proxy advisors do issue an *Against* recommendation and 1.7 (1.1) percent when they do not, with the tests of differences being significant at p-value < 0.01. The influence of proxy advisors continues to hold in a multivariate setting, as reported in Table 3, Panel B. Column 1 is reported for control variables only, and Column 2 includes the proxy advisor recommendation (*RecAgainst*). The results suggest that a proxy advisor *Against* recommendation can increase the percentage of dissenting votes by 6.7 raw percentage points. Standardized "beta" coefficients are reported to further demonstrate coefficient magnitudes. The statistical importance of proxy advisors as a determinant in the auditor ratification vote is also observed in the improvement in the explanatory power of the model. Specifically, the Adjusted R^2 increases from 6.3 percent to 19.4 percent when adding *RecAgainst*.

Table 3, Panel C includes the interaction between the control variables and *RecAgainst*. The results suggest that the influence of proxy advisors (*RecAgainst*) is stronger when nonaudit services are higher (*NAS*), auditor tenure is longer (*lnAudTenure*), the percentage of blockholders is lower (*Blockholders*), corporate governance is stronger (negative coefficient on *CEO_Chair*), general dissent against the company is higher (*DirVote*), and institutional ownership is higher (*Inst*). To provide context to these results, the additional influence of proxy advisors in the presence of higher institutional ownership is most likely due to the fact that institutional shareholders are a primary subscriber of proxy advisory services. Similarly, because blockholders are more likely to conduct their own research for companies in which they have a substantial investment of more than 5 percent, it is not surprising that the influence of proxy advisors is less pronounced when there is a larger percentage of blockholders in the shareholder base.

Factors Affecting Proxy Advisor Recommendations

In Table 4, Panel A, I report univariate statistics for each of the criteria used by proxy advisors in forming their recommendations. In Table 4, Panel B, I report the results of the estimation of Equation (2). Both univariate and multivariate results suggest that among the factors in the proxy advisor guidelines, the ones significantly associated with the proxy advisor's actual recommendations (*RecAgainst*) are (1) excessive nonaudit services (*ExcessNAS*), (2) legal limitations or alternative

TABLE 3

Proxy Advisor Recommendations on Auditor Ratification and Shareholder Voting

Panel A: Univariate Statistics

	***RecAgainst* = 0 (n = 8,765)**		***RecAgainst* = 1 (n = 238)**		**Tests of Differences**	
	Mean	**Median**	**Mean**	**Median**	**Mean**	**Median**
VoteAgainst	0.017	0.011	0.086	0.070	***	***

***, **, * Represent significance at the 0.01, 0.05, and 0.10 levels, respectively, based on two sample t-tests.
VoteAgainst is the percentage of non-insider votes cast against or abstaining from auditor ratification, presented in the decimal form.

Panel B: Multivariate Results, Equation (1)

		VoteAgainst					
		Column 1			**Column 2**		
	Prediction	**Coeff.**	**Beta**	**p-value**	**Coeff.**	**Beta**	**p-value**
Intercept		0.015		0.000***	0.015		0.000***
RecAgainst	+				0.067	0.362	0.000***
lnAssets		−0.001	−0.076	0.000***	−0.001	−0.072	0.000***
Returns		−0.001	−0.007	0.520	0.000	0.000	0.973
NAS		0.034	0.150	0.000***	0.030	0.132	0.000***
lnAudTenure		0.004	0.108	0.000***	0.004	0.103	0.000***
MWeak		0.009	0.044	0.082*	0.009	0.043	0.088*
Restate		0.001	0.009	0.379	−0.000	−0.000	0.976
Blockholders		−0.014	−0.077	0.000***	−0.015	−0.084	0.000***
CEO_Chair		−0.000	−0.003	0.836	0.001	0.010	0.360
DirVote		0.056	0.152	0.000***	0.053	0.144	0.000***
Big4		−0.000	−0.003	0.872	−0.001	−0.014	0.357
Inst		−0.002	−0.015	0.306	−0.002	−0.020	0.163
Year Fixed Effects			Included			Included	
n			9,003			9,003	
Adjusted R^2			0.063			0.194	

***, **, * Represent significance at the 0.01, 0.05, and 0.10 levels, respectively.
The dependent variable is *VoteAgainst*, the percentage of non-insider votes cast against or abstaining from auditor ratification. I estimate each model using ordinary least squares regression with robust standard errors clustered by company. I report both the coefficient (Coeff.) and the standardized coefficient (Beta). The p-value for the variable of interest, *RecAgainst*, is one-tailed based on the directional prediction. p-values for control variables are reported two-tailed.
All variables are as defined in Appendix B.

Panel C: Multivariate Results, Equation (1) with Interactions

	VoteAgainst	
	Coeff.	**p-value**
Intercept	0.016	0.000***
RecAgainst	0.024	0.523
lnAssets	−0.001	0.000***
Returns	0.000	0.792
NAS	0.024	0.000***
lnAudTenure	0.004	0.000***
MWeak	0.010	0.068*
Restate	−0.000	0.902
Blockholders	−0.012	0.000***
CEO_Chair	0.001	0.194
DirVote	0.048	0.000***

(continued on next page)

TABLE 3 (continued)

	VoteAgainst	
	Coeff.	**p-value**
Big4	−0.000	0.701
Inst	−0.004	0.012**
lnAssets ∗ RecAgainst	0.000	0.934
Returns ∗ RecAgainst	−0.008	0.677
NAS ∗ RecAgainst	0.124	0.000***
lnAudTenure ∗ RecAgainst	0.014	0.049**
MWeak ∗ RecAgainst	−0.015	0.428
Restate ∗ RecAgainst	0.002	0.866
Blockholders ∗ RecAgainst	−0.092	0.000***
CEO_Chair ∗ RecAgainst	−0.013	0.095*
DirVote ∗ RecAgainst	0.151	0.080*
Big4 ∗ RecAgainst	−0.040	0.115
Inst ∗ RecAgainst	0.058	0.000***
Year Fixed Effects	Included	
n	9,003	
Adjusted R^2	0.226	

***, **, * Represent significance at the 0.01, 0.05, and 0.10 levels, respectively.
The dependent variable is *VoteAgainst*, the percentage of non-insider votes cast against or abstaining from auditor ratification. I estimate the model using ordinary least squares regression with robust standard errors clustered by company. p-values are two-tailed.
All variables are as defined in Appendix B.

dispute resolutions between the company and the auditor (*LegalLanguage*), (3) restatements, and (4) aggressive accounting policies, proxied for by high discretionary accruals (*HighAbsDA*). In Column 1, I proxy for restatements using the broader measure *Restate,* set equal to 1 for any restatement announcement in the year before the meeting date, where the auditor subject to vote is the same one present when the misstatement occurred. In Column 2, I examine whether the classification of a "Big R" or "Little R" restatement (e.g., Scholz 2014) affects the association. I define those disclosed in an 8-K, Press Release, or NT filing as a "Big R" (*Restate_BigR*) and those disclosed in a 10-K, 10-Q, or other filing as a "Little R" (*Restate_LittleR*). Here, I find that the association is only driven by Big R restatements.

Why are Proxy Advisor *Against* Recommendations in Auditor Ratification So Rare?

In Table 5, Panel A, I report the number of observations falling into one of four categories for each type of suspect observation: Suspect? (Yes or No) and Proxy Advisor Recommended Voting Against Auditor Ratification? (Yes or No). I identify 42, 215, 112, and 512 observations as suspect because of excessive nonaudit fees (*ExcessNAS*), legal limitations (*LegalLanguage*), "Big R" restatements (*Restate_BigR*), and aggressive accounting policies (*HighAbsDA*), respectively. Proxy advisors issue an *Against* recommendation for 69 (29/42), 85 (183/215), 12 (13/112), and 4 (22/512) percent of these suspect observations, respectively. The Chi-square test of associations for each of these suspect groups and their respective proxy advisor recommendations is significant at p-value < 0.01.

Shown in bold in each set of results for the respective suspect groups is the percentage of total percentage of total observations where Suspect = "Yes" and Proxy Advisor Recommended Voting Against Auditor Ratification? = "No" (Table 5, Panel A). These results emphasize that relatively few *Against* recommendations would be gained if proxy advisors applied more scrutiny to *ExcessNAS* and *LegalLanguage* criteria, with up to 0.2 and 0.4 percent of all observations, respectively. However, additional scrutiny around the factors proxying for poor audit quality, *Restate_BigR* and *HighAbsDA,* could generate a substantial number of additional *Against* recommendations, with up to 1.1 and 5.5 percent of all observations, respectively.

The results of Equation (3) are reported in Table 5, Panel B using a reduced sample of 850 suspect observations, where any of *ExcessNAS, LegalLanguage, Restate_BigR,* or *HighAbsDA* are set equal to 1. I find that proxy advisors are less likely to issue an *Against* recommendation to companies with strong performance (*Returns*) or the willingness to disclose internal control issues (*MWeak*), and are more likely to issue an *Against* recommendation when the auditor tenure is longer, presumably because of concerns about auditor independence, or when the auditor is a Big 4 firm (*Big4*). These findings are important in understanding the factors that may exacerbate (*lnAudTenure, Big4*) or mitigate (*Returns, MWeak*) situations in which the proxy advisor is considering an *Against* recommendation.

TABLE 4

Factors Affecting Proxy Advisor *Against* Recommendations

Panel A: Univariate Statistics

	***RecAgainst* = 0 (n = 8,765)**		***RecAgainst* = 1 (n = 238)**		**Tests of Differences**	
	Mean	**Median**	**Mean**	**Median**	**Mean**	**Median**
ExcessNAS	0.001	0.000	0.122	0.000	***	***
LegalLanguage	0.004	0.000	0.769	1.000	***	***
Restate	0.035	0.000	0.067	0.000	***	***
Restate_BigR	0.011	0.000	0.055	0.000	***	***
Restate_LittleR	0.024	0.000	0.012	0.000		
HighAbsDA	0.056	0.000	0.092	0.000	**	**
SEC_CmtLtr	0.442	0.000	0.445	0.000		
LowAuditFees	0.148	0.000	0.176	0.000		

***, **, * Represent significance at the 0.01, 0.05, and 0.10 levels, respectively, based on two sample t-tests.
All variables are as defined in Appendix B.

Panel B: Multivariate Results, Equation (2)

		RecAgainst			
		Column 1		**Column 2**	
	Prediction	**Coeff.**	**p-value**	**Coeff.**	**p-value**
Intercept		−6.155	0.000***	−6.310	0.000***
ExcessNAS	+	6.948	0.000***	7.218	0.000***
LegalLanguage	+	7.904	0.000***	8.103	0.000***
Restate	+	2.124	0.000***		
Restate_BigR	+			3.751	0.000***
Restate_LittleR	+			−1.457	0.976
HighAbsDA	+	1.470	0.002***	1.439	0.004***
SEC_CmtLtr	+	−0.095	0.644	−0.103	0.659
LowAuditFees	+	−0.292	0.786	−0.191	0.689
Year Fixed Effects		Included		Included	
n		9,003		9,003	
Area Under ROC Curve		0.969		0.971	

***, **, * Represent significance at the 0.01, 0.05, and 0.10 levels, respectively.
The dependent variable is *RecAgainst*, set equal to 1 if the proxy advisor recommends that shareholders vote against auditor ratification, and 0 otherwise. I estimate the model using logistic regression with robust standard errors clustered by company. p-values are one- (two-) tailed when a prediction is (is not) made.
All variables are as defined in Appendix B.

DISCUSSION

Collectively, the results suggest that proxy advisors' recommendations are associated with shareholder voting for auditor ratification and that when compared to their guidelines, there appears to be variation in the extent to which proxy advisors issue *Against* recommendations. Below, I discuss two key aspects of these findings: (1) whether the association with shareholder voting is qualitatively significant, and (2) why there appears to be relatively low adherence with proxy advisor guidelines around suspected poor audit quality.

Is the Influence of Proxy Advisors Qualitatively Significant in Auditor Ratification?

While the 6.7 percentage point shift in dissenting votes for observations with an *Against* recommendation is statistically significant, it is less clear whether this shift is qualitatively significant for two primary reasons. First, the shift is substantially less than the 13 to 25 percentage point shifts documented in previous proxy advisor studies using other settings (Bethel and

TABLE 5

Evaluating Suspected "Missing" Proxy Advisor *Against* Recommendations

Panel A: The Frequencies of Suspect Observations and Proxy Advisor *Against* Recommendations

		Proxy Advisor Recommended Voting Against Auditor Ratification?			
Issue	**Suspect?**	**Yes**	**No**	**Total**	**Chi-square (p-value)**
ExcessNAS	Yes	29	**13**	42	5,600.000
		(0.3%)	**(0.2%)**	(0.5%)	(0.000)***
	No	209	8,752	8,961	
		(2.3%)	(97.2%)	(99.5%)	
	Total	238	8,765	9,003	
		(2.6%)	(97.4%)	(100%)	
LegalLanguage	Yes	183	**32**	215	7,300.000
		(2.0%)	**(0.4%)**	(2.4%)	(0.000)***
	No	55	8,733	8,788	
		(0.6%)	(97.0%)	(97.6%)	
	Total	238	8,765	9,003	
		(2.6%)	(97.4%)	(100%)	
Restate_BigR	Yes	13	**99**	112	139.173
		(0.1%)	**(1.1%)**	(1.2%)	(0.000)***
	No	225	8,666	8,891	
		(2.5%)	(96.3%)	(98.8%)	
	Total	238	8,765	9,003	
		(2.6%)	(97.4%)	(100%)	
HighAbsDA	Yes	22	**490**	512	420.785
		(0.2%)	**(5.5%)**	(5.7%)	(0.000)***
	No	216	8,275	8,491	
		(2.4%)	(91.9%)	(94.3%)	
	Total	238	8,765	9,003	
		(2.6%)	(97.4%)	(100%)	

***, **, * Represent significance at the 0.01, 0.05, and 0.10 levels, respectively.
Suspect firms are identified using the proxy advisors' published guidelines. The number of observations for each group is presented, along with a Chi-Square test of association between the groups. The percentage in parentheses represents the percentage of total observations (9,003).

Panel B: Multivariate Results, Equation (3)

	RecAgainst	
	Coeff.	**p-value**
Intercept	−3.795	0.000***
lnAssets	0.071	0.322
Returns	−0.914	0.082*
MWeak	−0.820	0.080*
lnAudTenure	0.421	0.008***
Big4	0.947	0.015**
Blockholders	0.394	0.553
Inst	0.724	0.163
CEO_Chair	−0.310	0.172
Year Fixed Effects	Included	
n	850	
Area Under ROC Curve	0.689	

***, **, * Represent significance at the 0.01, 0.05, and 0.10 levels, respectively.
The dependent variable is *RecAgainst*, set equal to 1 if the proxy advisor recommends that shareholders vote against auditor ratification, and 0 otherwise. I estimate the model using logistic regression with robust standard errors clustered by company, for only those observations where at least one of the proxy advisor criteria from Table 5, Panel A is present: (1) excessive nonaudit services (*ExcessNAS*), (2) legal limitations between the company and the auditor (*LegalLanguage*), (3) restatements (*Restate_BigR*), or (4) high discretionary accruals (*HighAbsDA*). p-values are two-tailed.
All variables are as defined in Appendix B.

Gillan 2002; Cai et al. 2009; Ertimur et al. 2013; Larcker et al. 2015). This may be at least partially due to the fact that Glass Lewis issues the majority of *Against* recommendations in my sample, and prior literature finds that the influence of Glass Lewis does not have as strong of an influence as ISS. For example, using say on pay, Ertimur et al. (2013) find that an ISS *Against* recommendation shifts the percentage of dissenting votes by 25 percentage points, compared to 13 percentage points for Glass Lewis. Similarly, using director elections, Choi et al. (2010) find a 20 percentage point shift for ISS compared to only 6 percentage points for Glass Lewis. Unfortunately, the number of *Against* recommendations in my study is so low for ISS, 12 observations total, that I cannot statistically examine this further.[16]

Second, even with the *Against* recommendation, the total percent of dissenting votes rarely reaches thresholds that the audit committee may consider necessary to make changes, especially in light of the fact that this is a voluntary vote asking for *ratification* of the audit committee's selection. Prior literature finds that management uses benchmarks such as 20 percent to indicate substantial shareholder dissatisfaction (e.g., Del Guercio, Seery and Woidtke 2008) and may not feel compelled to act when dissenting votes are below that level. Compared to more than 15 percent of observations in Ertimur et al.'s (2013) say on pay study with greater than 20 percent in dissenting votes, less than 1 percent of observations in my sample have dissenting votes in excess of 20 percent. Thus, the total effect of proxy advisor *Against* recommendations on shareholder voting may not be qualitatively significant.

Why are there so Few *Against* Recommendations for Suspected Poor Audit Quality?

Among observations triggering at least one of the significant proxy advisor recommendation criteria for concerns about either auditor independence or audit quality, proxy advisors issue a much higher percentage of *Against* recommendations to observations with suspected concerns about auditor independence (69 to 85 percent) than they do to suspected concerns about poor audit quality (4 to 12 percent). The seemingly "missing" *Against* recommendations around poor audit quality could be due to a number of factors.

First, companies may change the auditor prior to the shareholder meeting, thus removing the most egregious lapses in audit quality from my study. Untabulated, I find that the 222 observations dropped from my sample because of pre-meeting changes to the auditor do, in fact, have a higher rate of *Restate_BigR* than the sample firms. Specifically, 5.4 percent of dropped observations reported a Big R restatement in the year preceding the meeting date, compared to 1.2 percent in the final sample.

Second, proxy advisors' guidelines are based on feedback from shareholders. If shareholders do not respond to specific signals of poor audit quality, or if shareholders do not place a lot of emphasis on audit quality proxies listed in the proxy advisor guidelines, then proxy advisors will be less likely to issue an *Against* recommendation for poor audit quality absent obvious signals of audit failure. Availability bias (e.g., Tversky and Kahneman 1973) suggests that users of information consider information that "is easily retrievable . . . as being more likely, more relevant, and more important for a judgment" (Center for Audit Quality [CAQ] 2014, 11). Accordingly, proxy advisors may be less willing to issue *Against* recommendations based on suspected poor audit quality because it lacks clear and centralized disclosure. In a comment letter to the SEC, Darren Brady from Hermes Investment Management discusses this need for additional information (emphasis added):[17]

> We would note that it is not surprising that the typically non-binding resolution to ratify the audit firm's appointment or reappointment is almost always passed overwhelmingly in nearly all cases as the quality of the audit and the rigour of the audit committee's interaction with the audit firm is unclear from the current disclosure. *It is false to conclude from the voting patterns that investors are content with the current situation: instead typically investors seek to support the board and do not normally have enough information to justify not doing so*.

Mr. Brady's comment letter to the SEC aligns with remarks from SEC Commissioner Luis A. Aguilar in a 2012 speech at the National Association of the Public Pension Attorneys' 25th Anniversary Legal Education Conference, in which he encouraged investors to get more involved in monitoring audit quality (Aguilar 2012).

In 2008, the Department of the Treasury's Advisory Committee on the Auditing Profession recommended that key indicators of audit quality be identified and disclosed to assist shareholders with their voting decisions (ACAP 2008). Additionally, the SEC's (2015) Concept Release for "Possible Revisions to Audit Committee Disclosures" outlines eight potential disclosure changes related to auditor appointment and retention, because "[i]n those cases where a company

[16] Choi, Fisch, and Kahan (2009) find that in a sample of uncontested director elections, ISS is more likely to recommend *Against* a director based on governance-related factors, such as board attendance, busyness, independence, and responsiveness. In contrast, Glass Lewis is more likely to recommend *Against* a director because of audit- or disclosure-related factors, such as a prior restatement, SEC investigation, audit committee membership, etc. Thus, the relatively low number of *Against* recommendations from ISS may be due to lower policy interest in general related to audit and disclosure issues, when compared to Glass Lewis. All inferences in my study remain the same if I remove these 12 observations with *Against* recommendations from ISS.

[17] See: http://www.sec.gov/comments/s7-13-15/s71315-39.pdf/, page 2.

voluntarily seeks ratification of its auditor, requiring additional disclosure may be useful to promote informed voting decisions" (SEC 2015, 39006). To date, neither of these disclosure recommendations have taken effect. While the Center for Audit Quality and the PCAOB have begun projects that will determine the feasibility of defining, and requiring the disclosure of, audit quality measures in the future, these discussions are largely focused on disclosures for the audit committee, which would not be made available to shareholders unless audit committees voluntarily disclose the information (PCAOB 2012; CAQ 2013; PCAOB 2015). My findings may be useful to these discussions because they suggest that even a reasonably sophisticated user, such as a proxy advisor, often lacks clear enough evidence about poor audit quality to warrant issuing an *Against* recommendation.

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APPENDIX A

Proxy Advisor Guidelines

Glass Lewis (2011, 26)[a]

Reasons why we may not recommend ratification of an auditor include:

1. *When audit fees plus audit-related fees total less than the tax fees and/or other nonaudit fees.*
2. *Recent material restatements of annual financial statements, including those resulting in the reporting of material weaknesses in internal controls and including late filings by the company where the auditor bears some responsibility for the restatement or late filing.*

3. *When the auditor performs prohibited services such as tax-shelter work, tax services for the (Chief Executive Officer [CEO]) or (Chief Financial Officer [CFO]), or contingent-fee work, such as a fee based on a percentage of economic benefit to the company.*
4. *When audit fees are excessively low, especially when compared with other companies in the same industry.*
5. *When the company has aggressive accounting policies.*
6. *When the company has poor disclosure or lack of transparency in its financial statements.*
7. *Where the auditor limited its liability through its contract with the company or the audit contract requires the corporation to use alternative dispute resolution procedures.*
8. *We also look for other relationships or concerns with the auditor that might suggest a conflict between the auditor's interests and shareholder interests.*

ISS (2010, 2)[a]

Vote FOR proposals to ratify auditors, unless any of the following apply

1. *An auditor has a financial interest in or association with the company and is, therefore, not independent;*
2. *There is reason to believe that the independent auditor has rendered an opinion that is neither accurate nor indicative of the company's financial position;*
3. *Poor accounting practices are identified that rise to a serious level of concern, such as: fraud; misapplication of (Generally Accepted Accounting Principles [GAAP]); and material weaknesses identified in Section 404 disclosures;*
4. *Fees for nonaudit services ("Other" fees) are excessive. Nonaudit fees are excessive if: nonaudit ("other") fees > audit fees + audit-related fees + tax compliance/preparation fees.*

[a] These guidelines are consistent across all sample periods.

APPENDIX B

Variable Definitions

Variable		Variable Definition
Big4	=	an indicator variable set equal to 1 when the company's annual financial statement opinion is signed by a Big 4 auditor, and 0 otherwise (Audit Analytics).
Blockholders	=	the percentage of shares held by owners of 5 percent or more of the stock (in decimal form) (Corporate Library).
CEO_Chair	=	an indicator variable set equal to 1 if the CEO is also the Chairman, and 0 otherwise (Corporate Library).
DirVote	=	the mean of the percentage of votes cast against or withheld from the management recommended directors (in decimal form) (ISS Voting Analytics).
ExcessNAS	=	an indicator variable set equal to 1 if tax fees and other nonaudit fees are greater than audit fees plus audit-related fees, and 0 otherwise (Audit Analytics).
HighAbsDA	=	an indicator variable set equal to 1 if the absolute value of discretionary accruals is in the highest two-digit industry-year decile, and 0 otherwise, using all companies with available data. The absolute value of discretionary accruals (u) is estimated by year and two-digit SIC for all of Compustat, following Kothari, Leone, and Wasley's (2005) performance-adjusted modified Jones model (Jones 1991; Dechow, Sloan, and Sweeney) using lagged ROA (while retaining only those industry-years with a minimum of ten observations per industry-year). The model is as follows: $TA_{it} = \delta_1(1/A_{it-1}) + \delta_2((\Delta S_{it} - \Delta AR_{it})/A_{it-1}) + \delta_3(PPE_{it}/A_{it-1}) + \delta_4(ROA_{it-1}) + u_{it}$. *TA* is equal to total accruals under the indirect cash flow method (Hribar and Collins 2002) (income before extraordinary items minus operating cash flows from continuing operations); *A* is equal to total assets; ΔS is equal to the change in total sales revenue from the prior year; ΔAR is equal to the change in accounts receivable from prior year; *PPE* is equal to property, plant, and equipment; *ROA* is equal to net income divided by total assets (Compustat).
Inst	=	total institutional holdings divided by the total shares outstanding as of fiscal year-end, winsorized to 1.00, following D'Souza, Ramesh, and Shen (2010) (Thomson Reuters; Compustat).
LegalLanguage	=	an indicator variable set equal to 1 if the company discloses clauses in the audit engagement letter that allow for alternative dispute resolutions or limitation of auditor liability, and 0 otherwise (DEF 14A).
LowAuditFees	=	an indicator variable set equal to 1 if the ratio of audit fees to total assets is in the lowest 10 percent of two-digit SIC industry peers by year, and 0 otherwise, using all companies with available data (Audit Analytics, Compustat).
lnAssets	=	the natural log of total assets (Compustat).
lnAudTenure	=	the natural log of the number of consecutive years (through year t) during which the auditor has audited the company (Audit Analytics, Compustat).
MWeak	=	an indicator variable set equal to 1 if the company reported a material weakness in its 302, 404(a), or 404(b) disclosures, and 0 otherwise (Audit Analytics).
NAS	=	nonaudit service fees (total fees − audit fees) divided by total fees (Audit Analytics).
VoteAgainst	=	the number of votes cast against or abstaining from auditor ratification divided by (the total number of votes cast $*$ (1 − the percentage of shares held by insiders, in decimal form)), following Sainty et al. (2002) (Corporate Library; ISS Voting Analytics).
RecAgainst	=	an indicator variable set equal to 1 if the company receives an "Against" recommendation from a proxy advisor on auditor ratification, and 0 otherwise (Glass Lewis; ISS Voting Analytics).
Restate	=	an indicator variable set equal to 1 if the company files a 10-K restatement during the year preceding the meeting date and the auditor of record for the misstated period is the same auditor subject to the annual vote, and 0 otherwise (Audit Analytics).
Restate_BigR	=	an indicator variable set equal to 1 if the company files a 10-K restatement in an 8-K, Press Release, or NT filing during the year preceding the meeting date and the auditor of record for the misstated period is the same auditor subject to the annual vote, and 0 otherwise (Audit Analytics).
Restate_LittleR	=	an indicator variable set equal to 1 if *Restate* is set equal to 1 and *Restate_BigR* is set equal to 0, and 0 otherwise (Audit Analytics).
Returns	=	buy-and-hold returns for the 12 months preceding the meeting date, less buy-and-hold annual returns for the value-weighted portfolio (CRSP).
SEC_CmtLtr	=	an indicator variable set equal to 1 if the company received a comment letter on a 10-K or 10-Q filing during the year preceding the meeting date (measured using the EDGAR dissemination date) and the auditor of record for the period subject to comment is the same as the auditor subject to the annual vote, and 0 otherwise (Audit Analytics).