Retired Audit Partners on Boards: Yay or Nay?

By Lindsay Frost  November 8, 2019

Audit firms and companies are typically wary of allowing retired audit partners to serve as board members at companies where the audit firm is currently engaged, despite the time elapsed since the former partner served at the audit firm.

However, a new study published in *Auditing: A Journal of Practice and Theory*, a peer-reviewed publication of the American Accounting Association, indicates that former partners bring strong relationships and knowledge of firm practices to audit committees, which may lead to higher audit quality and lower fees. In addition, the audit chair position is among the most consistently demanding roles on the board and, therefore, difficult to fill let alone replace. A former audit partner could easily fit the bill for some boards.

Still, sources say boards should understand audit firm rules before they consider former partners in an audit committee search and discuss the risks of bringing the partner onto the board.

The Risks

One of the most important things boards should note about naming retired partners of audit firms to the board if the company is working with the firm are “cooling-off” periods, which specifically apply to engagement partners.

The SEC’s cooling-off period rule states that an audit firm is no longer considered independent if a member of the audit engagement team “commences employment with the issuer in a financial reporting oversight role,” which includes board positions along with C-suite financial executive positions, within a one-year period of completing the audit of the company.

However, rules are stricter elsewhere. For example, in the E.U. there is a required three-year cooling-off period, a rule that took effect in 2016. Also, New York Stock Exchange rules state that a director is not considered independent if he or she, or a family member, served as an audit partner or employee of the audit firm and “personally worked on the listed company’s audit” within the past three years. Nasdaq also requires a three-year cooling-off period.

And unwritten audit firm rules may be even stricter, says Dave Wilson, audit committee chair at Barnes & Noble Education and CoreSite Realty. For example, when he joined the board of Sylvan Learning in 2002, he had been retired from EY for eight years and hadn’t audited a company in even longer. But Wilson still had to break all the financial ties related to his retirement from the audit firm to ensure independence because Sylvan was a client of EY.
Wilson warns that some firms may even prohibit former partners from serving for a client company entirely, no matter how long the cooling-off period is.

Also, even if audit firms and companies are abiding by cooling-off policies and regulations, there could be a perceived reputational risk.

“If you have an alum of the accounting firm on your audit committee, it may create an appearance that they won’t be objective in evaluating the audit firm’s performance,” says Dan Goelzer, founding member of the Public Company Accounting Oversight Board, retired partner at Baker McKenzie and current member of the Sustainability Accounting Oversight Board. “[Partners do get named to boards], but I think people tend to stray away from it. If I was a retired partner of a firm, I would worry a little about the perception of a lack of objectivity.”

Also, Goelzer says this does not typically impact the recruiting process for audit committees.

“I don’t think boards typically go out and say, ‘Find someone from the audit firm that has been gone a few years,’” Goelzer says. “It needs to be a case-by-case determination.”

However, research shows the risks may be worth the rewards.

The study, Affiliated Former Partners on the Audit Committee: Influence on the Auditor-Client Relationship and Audit Quality, found “improved audit quality and increased effectiveness of auditor effort when affiliated partners serve on the audit committee.” The study also found a reduction in fees. Specifically, the companies with affiliated partners on the audit committee, on average, paid 3% lower in yearly audit fees than the other companies studied. Additionally, audit firm tenures at these companies tended to be longer, about 13 years compared to 11 at other companies.

Furthermore, the study found an association between affiliated audit committees and shorter audit report lags and increased audit effectiveness. On average, audit committees with a former partner on the committee received audit reports 63 days after the end of the year compared to 64 days at non-affiliated companies.

The study analyzed a sample of 22,840 Big 4 company clients between 2004 and 2012 along with publicly available data to identify audit committee affiliation on the partner level, which resulted in 6% of the companies having at least one audit committee member who was a partner at the firm. The study looked at financial restatements and late filings due to material weaknesses as the measures of audit quality. The researchers also conducted a survey of 46 audit committee members with the help of the Center for Audit Quality and the Tapestry Network to provide further insights.

The study did not distinguish former audit partners with former audit engagement partners who may have worked on specific companies’ audits. Professor Thomas Omer, professor of accounting at the University of Nebraska and one of the co-authors of the study, tells Agenda that the researchers picked partners to look at because they knew they were at audit firms a long time given the senior position, so “bonding and identification were much stronger.”

“This social theory and identification issue is an effective means of increasing the cooperation that we would expect between an audit committee and outside auditor,” Omer says.
However, Goelzer says, “the study suggests that, because the alum of the firm knows the firm, there is better communication between the auditor and the audit committee, and I suppose I can imagine that being true, but the audit committee is not typically involved in day-to-day auditing procedures.”

When it comes to processes, Omer says, the survey found there are fewer problems with such issues as getting documents on time when a former partner serves on the audit committee, because this person “knows how everything operates on the other side.”

“There are probably some good things that can happen in terms of audit efficiency, as partners know the process and there may be less downtime in waiting for things to happen,” Omer says. “These partners know how to get things done effectively to get financial statements done on time.”

Also, Omer says former partners want to properly oversee the audit because of their own reputations, according to the survey of audit committee members accompanying the study.

“[The audit firm and former partner’s] goals are aligned because the auditor doesn’t want to miss something and the audit committee doesn’t want to present financial statements that are inaccurate,” Omer says.

However, Wilson is skeptical and suggests that boards should ensure to note that correlation does not mean causation in the study. Also, audit committee members who are long-retired from their former firms may not know the internal processes that well and will most likely not know anyone personally from the firm, Wilson says.

At the same time, “there are only four large audit firms,” says Omer. “The odds that a partner is going to come around sometime and be matched up with an audit committee that employs that firm are pretty high.”