Disclosures on auditor firings are useless in forecasting restatement trouble, study shows

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Mandatory Securities and Exchange Commission disclosures about the reasons behind auditor firings are useless for assessing whether restatement trouble lies ahead for the company, according to new research from the University of Notre Dame.

Firing an auditor creates ambiguity. Is the company trying to find a better auditor, or is it trying to avoid a restatement (revision of previous financial statements to correct an error) for problems that the auditor is unearthing? And, while many restatements are the result of innocent mistakes and basic misinterpretation, some can raise red flags pointing to potential fraud or incompetence.

While most seasoned investors realize that companies tend to be cagey about their reasons for firing auditors, the research finds the disclosures are useless to an extreme. "Opaque Auditor Dismissal Disclosures: What Does Timing Reveal that Disclosures Do Not?" is forthcoming in the *Journal of Accounting and Public Policy* from Jeffrey Burks, the Thomas and Therese Grojean Family Associate Professor of Accountancy in Notre Dame's Mendoza College of Business, and Jennifer Sustersic Stevens of Ohio University.

In a sample of some 1,400 auditor firings, company revelations of disagreements with the auditor or other auditor concerns exhibit no systematic ability to forecast whether the company will restate its financial statements.

"The lack of predictive ability suggests that companies' decisions to disclose such auditor concerns are so inconsistent and uncommon—even though the regulation requires their disclosure—that no predictive power results," said Burks, who researches financial accounting and misstatements.

Instead of looking at what companies say in the disclosure, the researchers recommend investors pay attention to when the disclosure comes out.

"Any firing that happens after the second fiscal quarter signals an above-average chance of a future restatement," Burks said. "Firings that occur in the third or fourth fiscal quarters or during the period of audit fieldwork after year-end increase the chances of future restatement by roughly 40 percent."

The researchers reason that firings after the first half of the year are suspicious because companies almost always sign up auditors early in the fiscal year. Thus, most any firing that occurs after the early-year sign-up period means the company changed its mind about the auditor within the span of months.

"What would prompt such a quick change of mind?" Burks asked. "A prime possibility would be brewing disputes with the auditor about potential misstatements."

Despite this intuitive connection between late firings and disputes, the researchers find that companies are no more likely to disclose disputes for late firings than they are for early firings, again suggesting that companies tend not to be forthcoming about the underlying reasons for the firing.

The SEC has changed the disclosure regulation related to Section 4.01 8-K forms multiple times over the decades to try to force more transparent disclosure about firings, but the study shows such efforts have been ineffective. As an alternative to more rule changes, the researchers suggest the Public Company Accounting Oversight Board and the SEC begin to regularly ask about the circumstances of auditor firings in their examinations.

"The SEC may want to investigate the possibility of including questions about auditor firings in its comment letter reviews of individual companies," Burks suggested. "Such letters and the company responses to them already become public as a matter of course. The letters normally just stick to questions about the financial statements, but on at least one occasion the SEC asked about the reasons for an auditor firing, and received much more explanation than is normally included in the standard auditor firing disclosure."

For example, prompted by the SEC's question in a 2010 comment letter about why it fired its auditor, Blue Wave Group Inc. responded that the auditor misled the company about the expertise and documentation it possessed, did not have "the work ethic that the company felt was needed" and assigned a primary contact person who "was an associate still in school, not a seasoned professional."

The company also provided specific examples when the partner was "very difficult to work with" and "vague and unhelpful," and the company stated that it stuck with the auditor longer than it wished because "it felt trapped that it had a 10-K due and it did not want to file late."

More information: Jeffrey J. Burks et al, Opaque auditor dismissal disclosures: What does timing reveal that disclosures do not?, *Journal of Accounting and Public Policy* (2021). DOI: 10.1016/j.jaccpubpol.2021.106905

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