Should companies eliminate audits?

COMMENTARY by Eleanor Bloxham  JUNE 18, 2015, 12:28 PM EDT

Photograph by Joshua Roberts — Bloomberg via Getty Images
The current system for analyzing and auditing companies’ internal controls needs an overhaul.

Do the millions that large companies spend on annual audits actually provide the information investors need and are paying for? And are the earnings reports that companies produce trustworthy? If recent events offer any indication, the answer to both questions is likely a resounding no.

On June 8, the U.K.-based CCP research foundation reported that from 2010 to 2014, 16 global banks, including Bank of America, JP Morgan, and Citigroup, incurred $300 billion as a result of regulatory actions and other costs related to misconduct. The improper behaviors weren’t just related to actions before or during the financial crisis. Yet investors didn’t receive fair warning from the banks or their auditors about the multiple control weaknesses.

The problem certainly goes beyond big banks. According to a letter sent at the end of May from the U.S. Chamber of Commerce to the Securities and Exchange Commission and Public Company Accounting Oversight Board, the current system for analyzing and auditing companies’ internal controls needs a tune-up. The letter is timely.

The SEC is considering a few tweaks to the system. On June 5, the SEC’s chief accountant, James Schnurr, said the agency may propose greater disclosure requirements by corporate board audit committees on how they oversee their company’s auditors. And on June 14, the Financial Times reported that, “amid concern that accounting firms have become too cosy with the companies they oversee ... the US Securities and Exchange Commission [may require] compulsory disclosure of auditor tenure.”

But more than a few disclosures may be needed. A study published in the May 2015 issue of The Accounting Review analyzed over 650 company financial restatements. Only about 20% of companies provided investors any early warning about their material control weaknesses (5% of companies denied that a material control weakness led to their restatement). Of the remaining companies, nearly two-thirds fessed up to a material control weakness only after the restatement—while one-third just remained silent.

Why didn’t the firms alert investors sooner, as Sarbanes-Oxley requires? The study, which was performed by Texas A&M professor Sarah Rice and co-authors David Weber and Biyu Wu at the University of Connecticut, shows the system provides no incentive to come clean early on—and in fact,
there can be reasons not to. Do-gooders can suffer from harsher SEC actions, as well as higher rates of class actions and managerial and auditor turnover, the research found.

Former SEC Chief Accountant Lynn Turner told me the current accounting and auditing systems we all rely on need wholesale reform. Turner pointed me to other recent academic literature that drives home the point.

A June 2015 paper by professors from Emory University and Duke University found, in a survey of 400 CFOs, that, on average, chief financial officers believe that 20% of companies “intentionally misrepresent their earnings,” even though they are following the accounting rules. The paper also found that “the magnitude of the misrepresentation is large, averaging about 10% of reported earnings.”

Why does the system allow so much wiggle room? And how do so many companies get away with it? In a Winter 2015 article published in the California Management Review, Harvard Business School Professor Karthik Ramanna writes that the rules on accounting and auditing are examples of “thin political markets” in which those who have the most to gain set the rules. He attributes this in part to the esoteric (and boring) nature of these disciplines—and the fact that the media and the public have little appetite to act as a check on self-interests.

To illustrate how the systems work, Ramanna explains that only a handful of auditing and investment banking firms set the current rules for M&A accounting. Although most mergers and acquisitions destroy value, investment banks pushed for accounting rules that provide as much discretion as possible to show acquisitions in a good light. Auditors did not want to be on the hook for company’s questionable estimates. The resulting rules for M&A, which are called fair value accounting for goodwill, have allowed all of those at the table to win.

But what about the rest of us?

Turner argues that, for the system to work and investors to get the information they’ve paid for, major changes must be made. His first suggestion: provisions of the Securities Act of 1933 and the Securities Act of 1934 should be amended to remove the requirement that companies be audited. The audit firms are a “subsidized industry, like the credit rating agencies,” Turner told me, and companies are required to pay for “audits no matter the quality.” Instead, he recommends that every three to five years, investors vote on whether they want an audit. Turner says that would require auditors to “justify their existence to investors,” and this could “alter the behavior of auditors, as they would now be beholden to investors.” Turner says he’d also give shareholders the right to annually vote on the appointment of auditors selected by the audit committee. Audit committees on the new SEC rules should
Auditors selected by the audit committee. Audit committees are too often not as involved as they should be, Turner says.

Further, instead of having companies pay an audit firm directly, Turner would have the PCAOB collect money from the companies for the services that a board’s audit committee negotiates, using the same mechanism companies use today to pay the PCAOB for oversight of auditors. The PCAOB could demand a change in a company’s auditor if there were problems with an audit, Turner says.

The U.S. Chamber of Commerce has requested a meeting “of stakeholders” with the SEC and the PCAOB to discuss changes to audits. But Ramanna’s analysis suggests that all too often vested interests commit a “deception or fraud” on the public when they attempt to negotiate on the public’s behalf. While accounting and auditing may be a bore, the stakes in this battle for every one of us are high.

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