Study Finds CFOs Set Audit Fees, Ignore SOX Requirement (November 12, 2014)

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Summary: Two academics say CFOs are still setting the fees companies pay their outside auditors, despite a Sarbanes-Oxley provision that says boards’ audit committees are responsible for overseeing company dealings with their auditors. At this stage, it's not clear how the historical pattern of letting management run its business dealings with the auditors can be regulated more closely.

A recent academic study confirmed what many investors have believed: CFOs, not audit committees, generally determine the fees companies pay their external auditors.

Management historically negotiated audit fees, and this practice prompted concerns that auditors weren't serving investors. After the Enron scandal, Section 301(2) of the Sarbanes-Oxley Act of 2002 put the audit committee in charge of hiring, paying, and overseeing the auditors.

The study in the November/December 2014 issue of The Accounting Review published by the American Accounting Association questions whether the reform has been effective.

"Our results indicated that CFOs often continue to significantly influence the external audit fee negotiation despite regulatory requirements," according to research by Elaine Mauldin, an associate professor of accountancy at the University of Missouri, and Matthew Beck, now an assistant professor at Michigan State University.

Moreover, there's been enough anecdotal experience over the past decade that management, not the audit committee, is still in charge of negotiating the audit fees.

During a meeting of the PCAOB's Investor Advisory Group on October 20, 2014, in Washington, Joseph Carcello, a professor of accounting at the University of Tennessee, said the audit committee is the linchpin of Sarbanes-Oxley. The landmark governance reform law removes the CEO and CFO from overseeing the company's relationship with its outside auditors.
"In too many cases, that role has been, maybe not officially but in practice, has been abdicated, and the CEO and CFO still drive the relationship. Or the audit committee views their role as getting the cheapest audit fee," Carcello said. "I don't see how that can possibly be in the best interest of investors and consistent with good public policy."

Former SEC Chief Accountant Lynn Turner recalled a Las Vegas conference two or three years ago at which the 300 CEOs and CFOs in attendance were asked if they negotiated the audit engagement fees. All but five or six said it was their responsibility.

The researchers looked at data from 2006-2009, which included the worst of the financial crisis, a period that they surmised put unusually high pressure on management to mask financial problems and auditors to scrutinize clients's financial statements and reporting systems for signs of fraud.

"In an environment where the CFO interacts extensively with the auditor and often influences or controls fee negotiations, it may be unrealistic and misleading to investors to indicate that audit committees are ‘in charge,’" said the study.

"Influence is very hard to legislate, and we are not saying that firms are not in compliance with the letter of the law," Mauldin said in a phone interview. "The CFO can influence the fee negotiations even where the audit committee is formally ‘signing off.’ So, I am not sure it is an enforcement issue so much as making investors and other interested stakeholders who can examine the proxy statements and 10-Ks for information on the CFO and the audit committee aware of potential influence and helping audit committees ultimately overcome the historical patterns of influence."

Mauldin doubts that Sarbanes-Oxley's vision of strengthening the audit committee has been realized.

"The legislative mandate is pretty clear, and, given the staying power of historical patterns of influence, it's hard to imagine that further legislation will help," she said.

Turner said during the IAG meeting that no amount of regulation will solve problems of independence as long as the company is paying the auditor. He recommended setting up a mechanism similar to the accounting support fee in Sarbanes-Oxley that underwrites the operations of the PCAOB and FASB.

"We can do the same thing and put it into a pot of money," he said. Audit committees would still negotiate the fees but present the bills to the PCAOB.