

*Do stakeholders worry when firms hire members of the independent audit team?*

# The Value of ‘Cooling Off’

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Firms often find it both efficient and effective to hire accounting overseers who have previously served as members of the firm’s external audit engagement team. For example, a company’s external audit manager may be an appropriate controller or CFO candidate, or former audit partners may be appropriate board and audit committee members. Hiring former audit engagement team members is efficient because those individuals are already familiar with the company’s policies, practices, and corporate culture, requiring less “start-up” time and the cost of their practical training has been borne by the auditing firm. It is also effective, as those individuals tend to be well-educated, are already knowledgeable about the client’s industry-specific risks and internal control mechanisms, and they have an existing working relationship with client employees and those charged with corporate governance (e.g., board of directors, audit committee). Simply put, they are a known commodity.

The Sarbanes-Oxley Act of 2002 (SOX) mandated that an auditing firm’s independence is impaired if a former member of a public company’s audit engagement team (without regard to level, tenure, or extent of involvement) accepts a supervisory accounting position or financial reporting oversight role with the audit client, unless that individual observes a one-year “cooling off” period. We question whether investors prefer this “one size fits all” mandate, or whether a company-specific disclosure alternative would have equal or greater value relevance.

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## HIRING FORMER AUDITORS

Approximately 33 percent of CFOs at Fortune 1,000 companies have prior experience with their company's current auditing firm (Behn et al. 1999). This suggests that those charged with hiring decisions view such practices as enhancing value. While some companies adopting this practice have had questionable accounting practices and well-publicized frauds (e.g., Enron, Waste Management), the findings of empirical research related to the association between the employment of former auditors and earnings management are mixed.

Some studies suggest that the likelihood of earnings management and financial statement fraud increases in the period following the hiring of former employees of companies' external auditors (e.g., Dowdell and Krishnan 2004; Menon and Williams 2004; Beasley et al. 2000). Other studies, however, fail to find significant differences in earnings management (Geiger et al. 2005). Further, the results of Dowdell and Krishnan (2004) and Imhoff (1978) suggest that the strength of the relationship between earnings management and former auditor-CFOs, and financial statement users' perceptions of auditor independence, vary depending on the position formerly held in the auditing firm (partner or employee) and with the time gap between leaving the auditing firm and joining the company.

Contrary to the current one size fits all one-year cooling off period, the findings suggest that investors may value a relatively short cooling off period, with the length of the period dependent in part on the auditor's rank. Disclosure (in lieu of regulation) of such hirings, coupled with adequate corporate safeguards, may provide a more effective, efficient, and equitable method of addressing potential investor concerns.

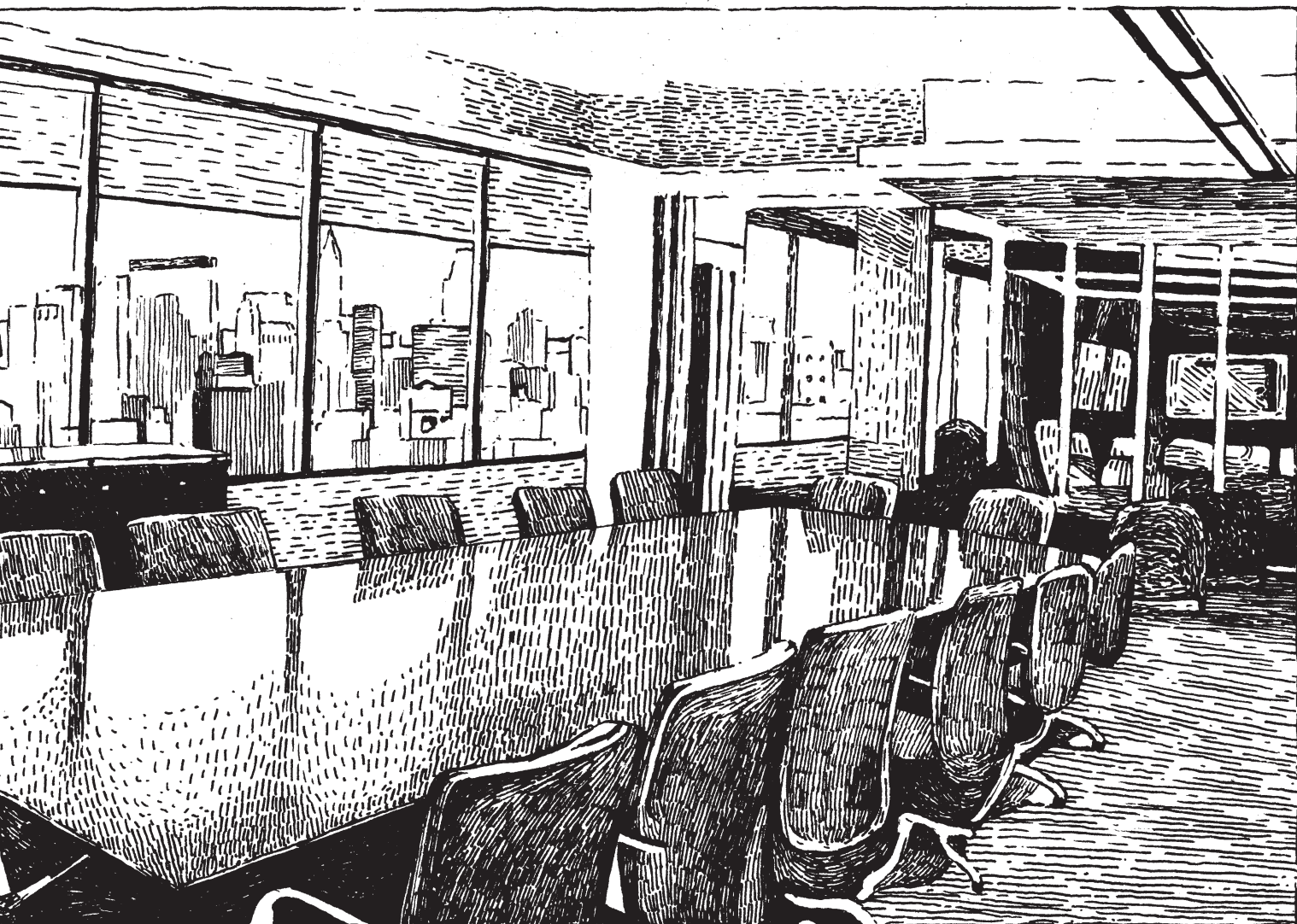
## REGULATORS' RESPONSE

Prior to SOX, SEC Rule 2-01 required that former auditors hired by audit clients in accounting positions or financial reporting oversight roles could not:

- influence their former auditing firm's operations or financial policies,
- have a capital balance in the auditing firm, or
- have certain types of financial arrangements with the auditing firm.

If any of those stipulations were violated, the auditing firm would not be considered independent of the client and could not remain as auditor.

In 2002, SOX mandated a one-year cooling off period for



firms desiring to hire external audit engagement team members into accounting oversight positions. For example, if a member of a company's audit engagement team is hired by a company in December 2007 — while the individual is working on the 2007 financial statement audit — the auditing firm would be precluded from rendering an opinion on the firm's 2007 and 2008 financial statements. In effect, if a company hires a current member of its external audit team, the company would also have to change auditors.

The intention of the cooling off period mandate was to increase the likelihood that auditors would remain independent. The SOX mandate presumes that auditors may feel a loyalty to their alumni and therefore may be less willing to maintain high quality auditing standards. Like many other provisions of SOX and similar regulations, the cooling off period is a one-size-fits-all solution, adopted without regard to the rank of the former auditor (whether staff, senior, manager, or partner), without regard to the former auditor's tenure on the engagement (whether it was one day or five years), and without consideration of corporate governance procedures that a company might have in place to reduce the likelihood that the auditing firm's independence could be impaired.

While there may be some potentially positive effects associated with the cooling off period, there are also negative effects. In particular, former auditors required to cool off for a period of time are not as familiar with the firm's current practices and intervening personnel changes may make them less likely to adapt to the company's changing culture. There is also evidence that "diligent" former auditors tend to be sensitive to the penalties of overly aggressive accounting positions (Bowlin et al. 2006).

We draw on the results of prior analogous research as evidence of whether investors are likely to prefer these types of one-size-fits-all regulatory solutions to potential auditor independence issues that ignore individual risk tolerances and company-specific corporate governance mechanisms over company-specific disclosures.

### **INVESTOR PERCEPTIONS OF ONE-SIZE-FITS-ALL**

A mandate analogous to the one-year cooling off period is the near elimination of auditor-provided non-audit services (NAS). Prior to 2001, external auditors were permitted to provide a wide variety of NAS to their audit clients, including internal auditing, appraisal, and financial systems design and implementation. Beginning in 2001, the Securities and Exchange Commission mandated that the provision of certain NAS was prohibited, other services were limited, and the fees paid for all audit and NAS paid to a company's external auditor were required to be disclosed. SOX extended the prohibition of NAS such that auditors are now banned from providing most NAS to their audit clients. Those opposed to the prohibition of NAS largely cited efficiency gains that would be lost; those in favor cited potential auditor independence issues.

There is no clear empirical evidence of a negative association between the independent auditor's provision of NAS and the quality of financial reporting (e.g., Frankel et al. 2002; Ash-

baugh et al. 2003) or auditor independence (Swanger and Chewning 2001). Further, the results of related prior research suggest that investors' perception of the provision of NAS is unclear. Krishnan et al. (2005) found a negative relationship between non-audit services and the earnings response coefficient (a measure of investors' perception of earnings quality) but Skantz and Higgs (2006) observed a similar negative relationship only when NAS fees were abnormally high. Surveying financial analysts, Swanger and Chewning (2001) found that using a company's external auditor to also provide internal auditing services was only perceived to be a problem in the absence of other corporate safeguards. Collectively, those results suggest that investors' reaction to auditor-provided NAS is likely, in part, to be dependent upon company-specific corporate governance characteristics. Further, they provide no clear evidence of whether the one size fits all solution of prohibiting NAS is value relevant to investors. Instead, required disclosures of the magnitude of audit and NAS fees, coupled with expanded SOX measures such as audit committee independence and identification of financial experts, allow investors to make more informed decisions regarding potential auditor impairment, while simultaneously preserving the benefits that some companies may experience when their auditor provides NAS.

### **INVESTOR PERCEPTIONS OF COMPANY-SPECIFIC DISCLOSURES**

Accounting standards and regulatory mandates prescribe a variety of accounting-related disclosures, including the disclosure of fees paid to auditors. To determine the value relevance of accounting-related disclosures, we review evidence of the market's reaction to two additional recently mandated disclosures: disclosure of material weaknesses in internal control over financial reporting and disclosure of reportable events when companies change auditors. If the market attributes value to those accounting-related disclosures, it is likely that investors will similarly attribute value to disclosure of the hiring of former auditors into accounting oversight roles at their former clients.

SOX Section 404 requires publicly traded companies to disclose financial reporting internal control deficiencies that are considered "material weaknesses." These are deficiencies that have a more-than-remote likelihood of resulting in a material misstatement of the financial statements. Cheng et al. (2006) studied the market's reaction to companies' initial disclosures of material weaknesses in internal control over financial reporting and found the market reacted negatively. Their findings suggest that such disclosure is value relevant to investors.

When a company changes its auditing firm, this must be disclosed on Form 8-K, filed with the SEC. The Form 8-K disclosures include:

- nature of the auditing firm's separation,
- name of the former auditing firm,
- name of the successor auditing firm, and
- existence of reportable events.



The former auditing firm is required to report its concurrence or disagreement with the 8-K disclosures. Reportable events are generally described by Financial Reporting Release No. 31, Reportable Event under Rule S-K, Item 3-04 (a) (1) (iv) and (v). They include disagreements on accounting principles, practices, or disclosures; material weaknesses in internal control; and the inability to rely on management's representations. Shu (2000), among others, found the market reacts negatively when auditor changes are characterized as resignations, but not when they are characterized as dismissals. Whisenant et al. (2003) found the market reacts negatively when auditor changes are accompanied by reportable events. Those findings suggest the market's reaction to auditor changes varies dependent upon the content of the disclosure; hence, the market attributes value to those accounting-related disclosures.

### VALUE OF COOLING OFF

The results of prior, related research provide evidence suggesting that:

- investors are likely to attribute some value to a cooling off period when companies hire their former auditors into accounting oversight positions,
- the value of a cooling off period varies with the auditor's rank, and
- investors are likely to attribute value to accounting-related disclosures.

As an alternative to the cooling off period, we suggest investors may be better served by companies disclosing when they hire former auditors, including the new hire's rank and tenure with the audit firm and the number of years on the client's audit engagement team.

Given the results of prior research, we expect that if investors believe the potentially adverse impact of hiring a for-

mer auditor exceeds the benefits, a company's investors will react negatively. Alternatively, if benefits are expected to exceed costs, it is possible that a positive market reaction would be observed upon disclosing the hiring of a former auditor. It is likely that the direction and extent of the investors' reactions to the hiring of a former auditor is, in part, dependent upon other company-specific governance and transparency factors. For example, a large company with a fully independent audit committee and a CEO owning less than 5 percent of the company's stock may not experience any market reaction upon hiring its former audit engagement team manager to be its CFO — even if no time gap exists between the time the CFO left the auditing firm and joins the company. Conversely, a small company with a CEO owning 51 percent of the company's stock may experience a negative market reaction when hiring a former auditor to a key accounting position — regardless of the time gap between positions.

Company-specific disclosures are likely an effective and efficient solution to auditor independence issues, as evidenced by investors' reactions to other accounting-related disclosures. If the market reacts negatively to former auditor hires, penalizing stock price or restricting access to capital, companies will likely voluntarily restrict their hiring of former auditors. Because the market tends to evaluate all available information in assessing corporate actions (including company-specific governance factors), disclosure would appear to be a more equitable alternative to the current one-size-fits-all regulation. R

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