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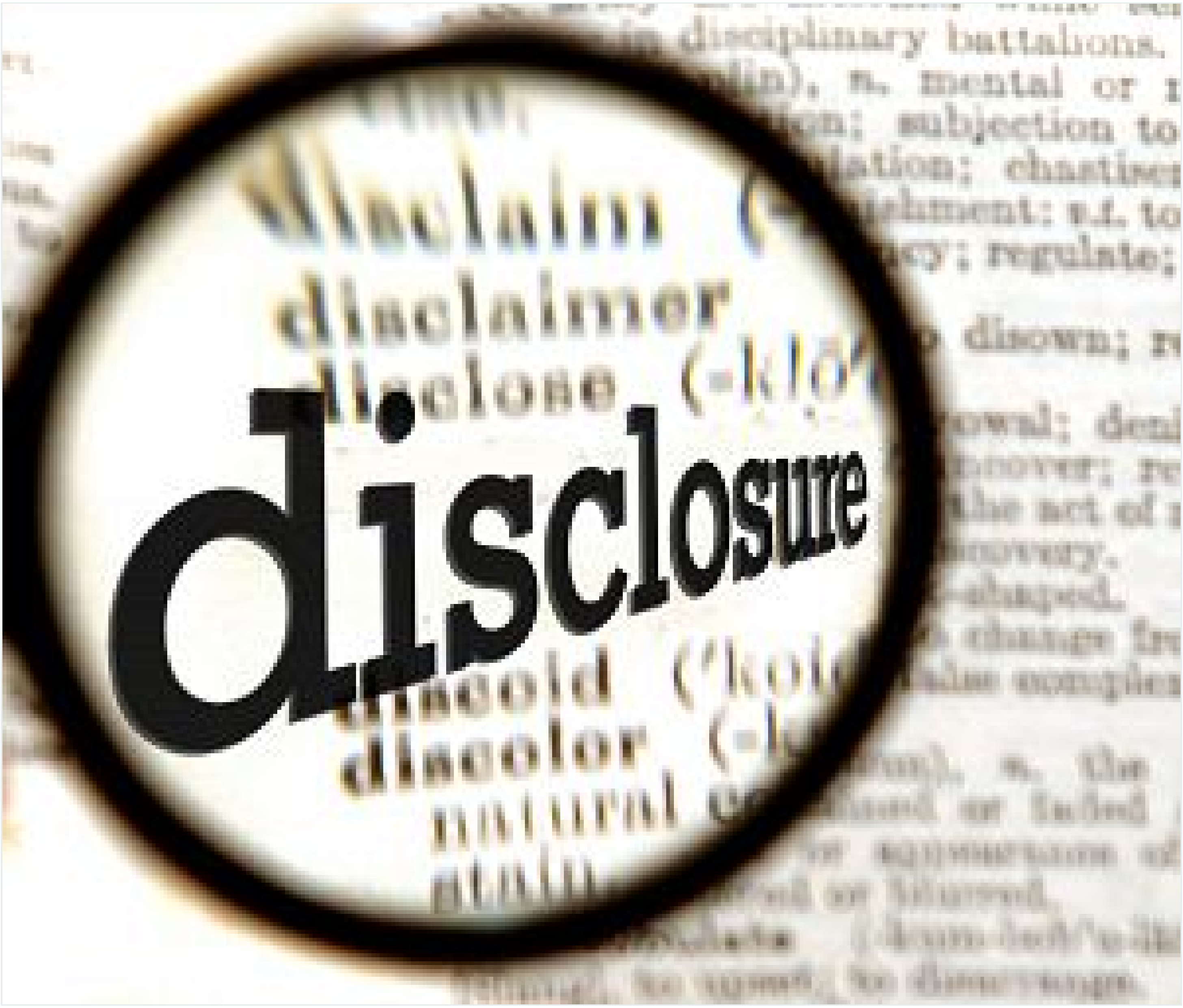


A regulation to be implemented January 31 in the U.S. requiring accounting firms to identify the principal engagement partner in corporate audits should be a solid plus for investors and regulators, a new study suggests.



clear how the new rule could greatly help investors recognize situations ripe for auditor conflict-of-interest.

Such situations are particularly likely to occur, the study finds, in interlock networks that arise when a member of a client's audit committee fulfills the same function in one or more companies that are also clients of the engagement partner. As the study puts it, "audit partner dependence on fees from [such interlock networks] erodes audit quality."

As an example, a co-author of the study, Gary S. Monroe of UNSW Australia, points out that in cases where an engagement partner earns over 10% of his or her annual fees from a distressed company's interlock network, the chance the firm will receive a going-concern opinion is less than half what it would be absent that degree of dependence. "With that much reliance on interlock network fees," he says, "the probability of a going-concern opinion – that is, an opinion explicitly raising doubts about the firm's future viability – is about 3.3%; without it, the probability is about 7.3%. Measured another way, it's a difference between 4.3% and 10%. Either way, it's a big difference."

Conducted by Prof. Monroe, his UNSW colleague Sarowar Hossain, Mark Wilson of the Australian National University, and Christine Jubb of Swinburne University of Technology, the study reveals the benefits of engagement-partner disclosure, required in Australia since the 1970s. Comments Prof. Monroe: "Our results strongly support requiring identification of the engagement partner. Coupled with disclosure of audit committee members and audit fees, it uniquely enables investors and regulators to identify interlocking networks likely to impair audit quality – as, for example, in willingness to issue a going-concern opinion."

The paper's findings assume particular importance, the professor adds, in view of earlier research that revealed that investors take kindly to interlocks between audit committees and accounting firms. “We found a significant deficit in audit quality



quality – 1) issuance of going-concern opinions for financially distressed companies and 2) amount of discretionary accruals. Discretionary accruals are non-cash accounting items that typically entail some element of guesswork (such as predictions of future write-offs for bad debts or estimates of inventory) and that are commonly associated with earnings manipulation.

Interlocks among audit clients were as follows:

- common audit-committee member and common audit-firm engagement partner
- common audit-committee member and common audit firm (but not engagement partner)
- common director not on audit committee and common audit-firm engagement partner
- common director not on audit committee and common audit firm (but not engagement partner)
- common audit-committee member but no common audit firm or engagement partner.

The first of these interlocks was uniquely associated with a low likelihood of going-concern opinions (as indicated above) and also with a high level of discretionary accruals. As Prof. Monroe explains, “In cases where engagement partners earned 10% or more of their fees from interlock-network clients, a firm’s discretionary accruals amounted on average to 9.3% of its assets; without that dependence, the mean level was 7.7%, almost one fifth lower.” As indicated above, high discretionary accruals are commonly associated with low reporting quality.

In sum, as Prof. Wilson observes, “knowing the specifics of interlocks between audit



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