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New Study Examines Proxy Advisor Recommendations on Auditor Ratification

MARCH 8, 2017

*E*ach year, the vast majority of larger public companies voluntarily ask shareholders to ratify the audit committee's selection of the company's auditor, and such proposals routinely pass with high rates of shareholder approval. Whether these votes reflect satisfaction with a company's auditor or shortcomings in relevant information is the subject of a recent study entitled "Auditor Ratification: Can't Get No (Dis)Satisfaction" by Professor Lauren Cunningham of the University of Tennessee business school. The study starts from the proposition that a major input for institutional investors in making voting decisions are the recommendations of proxy advisory firms. Less than 3 percent of auditor recommendations receive an *Against* recommendation from leading proxy advisory firms Institutional Shareholder Services (ISS) and Glass Lewis, and the study asks why the number of negative recommendations is not higher.

Based on a statistical analysis of 9,003 auditor ratification votes between 2009 and 2012 for which ISS and Glass Lewis made recommendations, the study makes two principal findings:

> *First*, negative recommendations had a statistically significant impact on the number of dissenting votes on ratification proposals, but less than the impact of negative recommendations in other areas, such as director elections, executive compensation, and non-routine proposals. The increase in dissenting votes on auditor ratification is approximately 6.7 percent, whereas in other areas, the increase in dissenting votes following a negative recommendation can range from 13 to 25 percent. The study suggested that the qualitative significance of the increase in dissenting votes may be further diminished because the total percentage of dissenting votes on auditor ratification rarely reaches thresholds that the audit committee might consider warrant changes.
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> *Second*, the proxy advisors make *Against* recommendations in fewer cases than might seem to be justified when their stated criteria raise concerns about the auditor. The study concluded that proxy advisors appear to issue a much higher percentage of *Against* recommendations in cases of concerns about auditor independence (as indicated by high non-audit fees or lengthy auditor tenure) than they do for concerns about poor audit quality (as indicated by such things as

> material restatements and aggressive accounting policies). One explanation, the study suggested, might be that because proxy advisors' guidelines are based on shareholder feedback, if shareholders tend to overlook subtle signals of poor audit quality, proxy advisors are less likely to issue an *Against* recommendation. Accordingly, the lower number of recommendations based on audit quality may result, among other contributing factors, from a lack of readily available public information on which to assess audit quality.

The study does not make any formal recommendations. However, it strongly implies that increased disclosure that allows better assessment of audit quality would be desirable. The author quotes an institutional investor, who observed that overwhelming votes in favor of ratification are not surprising because "the quality of the audit and the rigour of the audit committee's interaction with the audit firm is unclear from the current disclosure." The investor asserted, "It is false to conclude from the voting patterns that investors are content with the current situation; instead typically investors seek to support the board and do not normally have enough information to justify not doing so." In conclusion, the author suggests that "even a reasonably sophisticated user, such as a proxy adviser, often lacks clear enough evidence about poor audit quality to warrant issuing an *Against* recommendation."

Given the new regulatory environment in the Trump Administration, it seems unlikely that there will be regulatory actions in the foreseeable future to require additional audit committee disclosures relating to audit quality. However, since the periods of the auditor ratification votes that were the subject of the study, there has been a major trend in favor of voluntary audit committee disclosure, including providing more information about the committee's reasons for recommending retention of the auditor (see our prior posts on February 23, 2017, November 3, 2016, September 30, 2015, and August 21, 2015). This development may address, at least to some extent, the concerns identified in the study.