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TRANSCRIPT

ESG Now Podcast
"The Audit World on Fire?"

Transcript, 2 February, 2024

Mike Disabato (00:00):

What's up everyone? And welcome to the weekly edition of ESG Now, where we cover how the environment, our society and corporate governance effects and are affected by our economy. I'm your host, Mike Disabato, and this week we're discussing something that might seem mundane, but is really important audits and the firms that conduct them. Thanks as always for joining us. Stay tuned.

(00:29):

The Financial Times has this whole series out right now called The Big Flaw Auditing in Crisis, and it's pretty scathing. I'll tell you. It's all about how auditors are too close to their clients and hiding secrets from everyone. And that the Big four oligopoly made up by KPMG, Deloitte, Ernst and Young or EY and PWC is hurting competition. I read it and I got to say I was feeling the panic because audit firms are fundamental to the proper functioning of our economy. They ensure that a company's reported figures give the true and fair representation of its assets, liabilities, financial position, and profit or loss. They're the reason why I can go to a 10 K report and be certain that what it's saying is true and honest, and the reason why I'd feel comfortable investing in a company in the first place. It's also why an auditor has so much power.

(01:18):

If an auditor says the company's financial reports aren't good, aren't kosher, aren't to be trusted, then the public can't trust that the company is actually showing its true underlying financial performance. They have to assume something else is going on. So this is an important claim that the FT is making, and I had to know whether this claim of crisis was a true one. Now, luckily, auditor quality is something we very much care about at M-S-C-I-E-S-G research, and it's an increasingly important part of our governance research. So I was able to call up my colleague John, who has spearheaded our auditor quality research, and I was able to put this question to him about a crisis, and he told me what was going on, and I'm going to apply all that for you. But first, I need to at least tell you how to assess auditor quality because it's not self-evident.

(02:10):

And to do that, you have to learn about the pillars of a quality audit. And I'm going to list those to you now in no particular order. First, you have to realize that an audit varies by region. So if you have an auditor based in Germany and it's auditing a company in Thailand, you may have a problem on your hands. And then you need to think, does this auditor have

the resources to effectively conduct an independent audit? Or are they so dependent on the company that they're auditing for their livelihoods, like that company's their only client, that they're too afraid to challenge the company on its finances. Next, what's the auditor's experience? Did they just become a thing or have they been around for decades? And lastly, what's their regulatory inspection track record? Have they had regulators in there poking around and saying that we've been finding some deficient audits you've been making. So now that we know what to look out for, John can go through those pillars brick by brick and tell us all how worried we should be. So let's start off with the last pillar just to show you that the order that I listed those in didn't matter, deficiency rates and audits. What are deficiency rates and audits? Because I know what a deficiency is, but what does it have to do with an auditor and why is it so important? I asked John.

Jon Ponder ([03:27]):

Deficiency rates are tabulated when regulators take a look at a section of audits completed by a particular audit for in a year, and essentially they will run through these audits and tabulate any cases where material error was made within that particular audit. And what we noticed over the last year between 2022 and 23 is that this proportion is actually risen by 200% within the United States, UK and India to over 50% of all audits investigated,

Mike Disabato ([03:59]):

Over 50% of audits investigated are deficient. Man, it sounds like what John is saying there is that 50% of audits are not good, are suspect. And I was kind of taken aback when I first heard him say that, and I told him. So he called me down and then he freaked me out again. So

Jon Ponder ([04:16]):

This is only for a selection of audits completed by a firm. And in the case of the United States, they typically target high risk audits. So although this is not a damning indication that the firm itself is making mistakes and more than half of their audit engagements, it is a signal that there are some serious issues in compliance or execution going on at that firm.

Mike Disabato ([04:40]):

Okay, V. There's a bit of a selection bias, but still even accounting for selection bias, that seems like a lot. What about the other pillars? Let's talk about the relationship between the company and its auditor. And basically, you want an auditor to be in a polyamorous relationship. You do not want monogamy for your fair auditor where they have one love and if that love leaves, they are screwed. You want a whole field of relationships where hard truths can be told and the auditor won't be worried about losing their livelihood if they're fine. So I asked John about the relationship status of the world's auditing companies.

Jon Ponder ([05:16]):

When we examined our coverage universe of roughly 12,000 issuers, breaking them down by the auditor who's engaging with them. Roughly 9% of those audit firms were found to have that particular issuer as their only public company client. This could create somewhat of a conflict of interest when it comes to discussing impartiality and their ability to do a fulsome audit without untoward influence on the part of that company. As this particular auditor is fully reliant upon that issuer for their public audit fees, in essence, they're their only client and thus have a outsize influence on their ability to perform their job well and without bias.

Mike Disabato ([06:01]()):

Now, uncouth actions happened at large companies as well. Just take these scandals that have happened at the big four auditing firms last year. PWC has been dealing with a scandal since May, 2023 where a leak showed that the auditing firm used confidential government tax plans to advise tech clients that they called their brand defining clients. Deloitte was fined over 30 million US by China in March of last year for failing to perform its duty and assessing the asset quality of a company called China Huong Asset Management. And the EY was banned from some audits in Germany in April of last year for its role in the Wirecard scandal. And KPMG was fined 26 million US by the UK for a textbook failure in audits of Carilion, the builder that imploded in 2018. It prompted a deep review of auditing standards in the country. So problems can happen anywhere no matter the size of your firm, but they can especially happen when you just have one client that is supporting your entire company.

([07:06]()):

And if you try to challenge them too hard and they flee, then you're in a lot of trouble. So now let's look at the last two pillars, experience and ability. And we can kind of group these two together, I think, because they often walk hand in hand. And when I think of experience and ability, I kind of also think about 10 year how long that firm has been around and the size of the firm. And so the big four, they've been around for a long time and they're massive. So does this mean that every company should just flock to the big four for their auditing needs? I asked John about that.

Jon Ponder ([07:40]()):

Well, that's a difficult question to answer because in one sense, you could argue that the larger firms have more capacity of larger breadth of experience and possibly more senior individuals to handle fringe cases than some of the smaller firms. But on the other hand, if the entirety of our capital markets are reliant upon a small segment of these professional firms to perform these audits, then of course those individuals are going to be spread too thin. It's somewhat of a balance because conversely, the smaller firms obviously do have less personnel and by nature will thus also be thinly spread if they take on too much of a book of business than they can handle. But when you actually look at the entire landscape of auditors, there doesn't seem to appear to be a bias either to large or small audit firms from a perspective of quality, diligence, care, whatever metric you want to use.

(08:41):

And even beyond that, many of these audit firms and issuers have had relationships that extend back decades. So separating these auditors from the firms they audit and also onboarding new ones, whether they be big or small, is a costly time consuming process, which also has some dangers. You have to be capable of quickly picking up counting norms of understanding the core business that you're looking at, understanding how exactly their financial statements are engineered. It's never as simple as just picking someone up and dropping them just because they're good or bad, for lack of a better word.

Mike Disabato (09:22):

What it does require is investors to probably be aware of the sort of relationships the companies they're invested in have with their auditing firms, using maybe some of the techniques that John just mentioned. Okay, so now we've gotten to the point of the story where we are able to answer the question posed at the top of the show. Is the FT right to use the word crisis when talking about the auditing industry? Is the industry facing trouble and is there immediate action that needs to be taken? I ask John,

Jon Ponder (09:54):

While the word crisis is perhaps a little bit alarmist, we do have to contend with a serious shift in the labor market for accountants coming in the immediate future, roughly three quarters of the CPAs in the United States are at retirement age or are quickly approaching it. And at the same time, we have a tightening of individuals, the youth who are interested in pursuing accounting as a profession, which will throttle the existing talent pool, but also prevent additional entrance from supplying that dearth, which will be generated by these retirees. Now, despite the fact that we might be in for some lean times for people to fill this vacuum, I think that there is some opportunity, serious consideration of how we revitalize this industry, but also how we change some of the fundamental practices and attitudes that these accountants maintain.

Mike Disabato (10:52):

Those numbers that John just mentioned, the three quarters ready for retirement are just US numbers, because it was difficult to find detailed public data on audit firms, labor pools outside the us, but the scenario that he's talking about where there's a lack of accounting talent in the us, there's also a possibility when that happens that people from areas with lower wages in the US see this global shift in auditing talent and decide to come out to the US and try to get some of the larger wages that are possible, meaning that the crisis of talent in auditing labor pools in the US can create a global shift in auditing prowess away from areas like the emerging markets toward more developed countries like the us. So to put a bow on this episode, John doesn't see a crisis right now, but some storm clouds are definitely amassing in the distance. And that's it for the week. I wanted to thank John for talking to me about the news with an ESG twist. I wanted to thank you so much for listening. If you'd like what you heard, don't forget to rate and review us and subscribe if you want to

hear myself or any of the other co-hosts of ESG now each week. Thanks again and talk to you soon.

Speaker 3 ([12:19]):

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