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"Commentary: When watchdogs go astray" by Jonathan Uslaner (as published by Pensions & Investments)

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Commentary: When watchdogs go astray

by Jonathan Uslaner and Julia Johnson
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The investment community relies on the accounting industry to prevent misconduct and fraud. But what happens when the auditors of corporate America fall down on the job and betray their mandate to ensure transparency and accuracy in financial reporting? Investors endure massive losses — as we saw after a series of audit failures related to massive and widespread securities fraud in the early 2000s.

Unfortunately, the auditing profession continues to be plagued by misconduct: auditors ignore repeated warnings by whistleblowers, turn a blind eye to questionable receivables, change calls on the propriety of problematic accounting by clients and even undermine the regulatory agencies tasked with monitoring them.

That said, the institutional investor community is uniquely positioned — and has proven able — to hold auditors accountable. There is much that it can and should do to continue to improve the landscape.

Gatekeepers gone wrong

In the words of Securities and Exchange Commission Chairman Jay Clayton: "Audited financial statements are at the heart of the SEC's disclosure-based regulatory regime ... independent audits give investors confidence that those statements can be trusted."

Yet, auditors face a conflict of interest between their clients' interests and public transparency, and many audits frequently mislead investors. The International Forum of Independent Audit Regulators has found that 40% of the 918 audits inspected last year contained serious errors, including issues pertaining to accounting estimates and internal control testing. Frequently, accounting estimates are not based upon reasonable assumptions and do not consider contrary or harmful facts. Internal control testing might not sufficiently test for the accuracy and completeness of information provided by the client's managers. And bad financial news is frequently buried in "obscurely worded notes."

Over the past few years, numerous high-profile audit scandals have involved the so-called Big Four accounting firms — PwC, Deloitte, KPMG and Ernst & Young. These scandals have involved high-profile companies in the U.S. and internationally, including Petrobras (Brazil), BHS (U.K.), Carillion (U.K.) and major state institutions. Despite these scandals, the Big Four continue to monopolize the industry and audit more than 95% of the U.S.' largest companies.

Further, in January 2018, the U.S. Attorney for the Southern District of New York charged three executives at KPMG with multiple criminal and civil violations, including conspiracy, wire fraud and misuse of confidential information related to the firm's attempts at corrupting the function of the Public Company Accounting Oversight Board, a key regulator of the industry. Among other revelations, the indictment details how KPMG hired former PCAOB employees who then provided stolen confidential information detailing upcoming audit inspections.

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Troubling trends

Investors can and must fight back against auditor fraud.

While it is not particularly common to sue outside auditing firms, the institutional investor community has had significant success over the past two decades holding auditors accountable, obtaining billions of dollars in recoveries through securities class actions. Recently, this has even become a global phenomenon. In Australia, PwC recently paid $67 million to resolve a securities class action. In Canada, Ernst & Young was required to pay $118 million in 2012 in what

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