



# In the aftermath of company scandals, auditors charge higher fees or leave

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When thousands of fake Wells Fargo accounts came to light in 2016, the media scrutinized everyone behind the scandal, with the bank's external auditor, KPMG, sharing print space in nearly every article. A new study from researchers at University of Colorado Denver, Bentley University, and Northeastern University found that the media blowback related to environmental, social and governance (ESG) scandals is now landing on the shoulders of financial auditors. With their reputations increasingly tied in with the companies that contract their work, auditors are now increasing their fees or leaving altogether in the wake of company misconduct

"Financial statement auditors are not responsible for identifying all fraud," said Jenna Burke, Ph.D., assistant professor of accounting in the Business School at CU Denver. "If they detect significant fraud, they must report it, but their job is really to act as a second check of the financial report, making sure it is 'free of material misstatement.'"

In the case of KPMG, Wells Fargo's auditor for 85 years, many believe the scrutiny was deserved, and it went on to harm their reputation: the firm admitted they were aware of "instances of unethical and illegal conduct by Wells Fargo employees, including incidents involving these improper sales practices," but found no reason to report acts that did not have a "meaningful impact on a company's financial statements or its system of internal controls over financial reporting." While the Wells Fargo case is particularly troublesome, auditor involvement in these media scandals is typically more nuanced, said Burke.

“Legally, auditors do not generally have influence over nor responsibility for client ESG practices,” said Burke. “In the past, negative media coverage of these events hasn’t influenced their behavior, but that’s changing.”

And it’s changing with the speed in which scandals blow up on social media and eventually find themselves on the front page of The Wall Street Journal, like Chipotle’s E. coli outbreak or Volkswagen’s emissions cover-up. The attention on these events resulted in investigations, decreased brand perception, and damage to financial performance; criticism caused stakeholders to question company integrity and spiraled into litigation and consumer boycotts.

The variety of risks suddenly became relevant to the audit. Then a 2016 rule from the Federal Communications Commission (FCC) and Public Company Accounting Oversight Board (PCAOB) required the auditor’s name on the financial report, adding more visibility and pressure to the individual who signs off on the reports.

As a result, negative media coverage of a company is increasingly associated with a higher likelihood of auditor resignation or increased audit fees, according to Burke’s research.

Using a new dataset called RepRisk, the research examined this new area of audit risk not traditionally covered by financial statement auditors nor examined by prior research. They examined auditor response to negative media coverage of their client’s ESG practices in over 80,000 media sources. These new areas of risk include, for example, overuse and wasting of resources (environment issue); impacts on communities, social discrimination, and child labor (social issues); corruption and bribery, and anti-competitive practices (governance issues).

Researchers found that movement from the 25th to 75th percentile of negative media coverage represented a 19.5% increase in the likelihood of auditor resignations and a 4.68% increase in audit fees. They also found that while all issues increase the cost of the audit, auditors are more likely to resign over negative media coverage of governance practices, but not over environmental or social issues.

“Auditors should take note from the Wells Fargo scandal and be aware that, right or wrong, their reputations are intertwined with their clients’,” said Burke. “Ideally, auditors will use the media as a tool for identifying client risk and covering their bases. For instance, our research suggests the average audit firm does react by increasing fees. By doing more work to ensure the financial statements are free of material misstatement in the wake of these scandals, the auditor can hopefully escape negative reputational spillover and remain a watchdog of the capital markets.”