

loading...

# AGENDA

## EY Problems a 'Nightmare' for Directors

By Jennifer Williams-Alvarez July 13, 2020

German payments company **Wirecard** revealed last month that roughly \$2 billion was missing from its accounts. For years, Big Four audit firm **EY** had audited the once celebrated fintech company, but auditors in the German office failed to directly verify that the cash existed, according to the *Financial Times*.

EY tells *Agenda* that the sophistication of Wirecard's apparent fraud made it difficult to uncover. The firm has braced for fallout, the *FT* reports, and directors tell *Agenda* that EY is working to allay concerns. Still, board members express dismay about EY's audits of Wirecard. "You really do rely on your outside auditor to be a partner to the audit committee and to the board," says **Jane Scaccetti**, audit committee chair at **Myers Industries**. "So when something like this happens, you don't know who to trust. Management, outside auditors — the trust goes away."

As a director, "this is what you fear," adds Scaccetti, CEO and founding partner at tax advisory firm **Drucker & Scaccetti**. "This is exactly your nightmare."

What the concern will mean for EY is unclear, however. While displeased with the headlines, one audit committee chair says there will inevitably be some problematic audits from a firm the size of EY. "Given a company with 85,000 audit professionals, unfortunately, you're probably going to have a few difficult audits," says the public company director, who spoke on condition of anonymity.

"If you assume that there are perhaps 30 audit professionals on an audit of a public company, that's less than one tenth of 1% of the audit staff at EY," the director says. "It would certainly take a meaningful number of highly problematic audits before it would make me reconsider using the firm."

Scaccetti, meanwhile, plans to discuss the Wirecard circumstances with auditors from EY, which is the audit firm for Myers. "Though I'm certain they will raise it," she adds, speaking from experience.

Less than a year ago, Scaccetti recalls, EY landed in hot water related to leadership training. Roughly 30 female executives were advised during a training presentation not to be shrill or “flaunt” their bodies and to be well groomed, HuffPost reported last year. The former audit chair at Myers, **Robert Stefanko**, planned to have a conversation with EY about the training, but an EY audit partner “raised it before we had the chance,” Scaccetti notes.

Asked what assurances she will be looking for on the Wirecard matter, Scaccetti explains she does not have an easy answer. “I will have to hear what they say.”

### **Missing Cash**

In 2015, the *FT* began publishing a series of articles about inconsistencies in Wirecard’s accounting, issues that were rebuffed by the company and then-CEO **Markus Braun**. Wirecard raised €500 million from shareholders between 2011 and 2014. The embattled company once had a market value of €24 billion and was included in the Dax 30, an index consisting of 30 major German companies. However, the *FT*’s investigation — which followed a 2008 report from the head of a German shareholder association suggesting balance sheet issues at Wirecard — at one point found a more than €250 million gap in the company’s balance sheet.

Following an *FT* report on documents that showed certain profits were fraudulently inflated, and in response to pressure from investors, Wirecard brought in **KPMG** in October of last year to undertake a special audit. In an April 27 report, KPMG said it faced obstacles in conducting its audit, and that the firm was not able to verify a major portion of Wirecard profits.

Years after questions were initially raised, Wirecard, which declined to comment, warned of the missing \$2 billion on June 18. Braun stepped down as CEO on June 19, leaving newly appointed chief compliance officer **James Freis** to take over as interim chief executive, and the firm has filed for insolvency. Braun was arrested and released on bail, and a second senior employee, **Oliver Bellenhaus**, was arrested last week, according to the *FT*.

Wirecard’s collapse has also focused a harsh light on EY. Between 2016 and 2018, sources told the *FT*, the audit giant failed to directly confirm that significant amounts of Wirecard’s cash were held by a bank in Singapore. EY instead relied on assurances from Wirecard and a third-party trustee, the *FT* reported.

EY tells *Agenda* that it appears “Wirecard’s collapse is the product of a wholly exceptional,

large-scale, highly sophisticated fraud.”

“It seems this fraud was expertly designed to circumvent all the checks and balances, including reviews conducted by investigating parties, including at least a special investigator and EY audit procedures,” the firm continues in e-mail commentary. “It’s also clear that this fraud involved the collusion of multiple individuals at third-party entities; its objective was to deceive investors and the public.”

EY, which according to a spokesperson is limited in commenting by market disclosure and confidentiality rules in Germany, says it was provided false bank confirmations and statements related to Wirecard’s 2019 audit. “[W]e cannot rule out that prior years’ documents and confirmations are suspect.”

EY additionally stresses that Wirecard cash was kept in trustee-controlled accounts, which are “governed by varying contractual arrangements which often require customized audit procedures.”

“It’s understandable that auditing cash in a trustee account is more difficult than auditing cash in an account solely controlled by the company,” the anonymous audit committee chair says. “But you still have to find a way to verify the cash on a balance sheet to complete an appropriate audit.”

Board members and audit professionals are willing to concede that fraud can be hard to detect by auditors. “It’s very hard, especially if it’s collusive fraud,” Scaccetti says.

That is not to say fraud detection is completely outside the realm of auditors’ responsibilities, though, says **Robert Cox**, a former assistant director in the **PCAOB**’s division of enforcement and investigations. It may be true that a traditional audit of financial statements does not include fraud detection, says Cox, now a partner at law firm **Briglia Hundley**. But auditing standards from the PCAOB stipulate that auditors have a responsibility to “obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud,” he notes, quoting one of the standards.

Scaccetti describes it as a “real concern” for directors, and particularly for audit committee members, that outside auditors follow generally accepted standards for auditing. “If EY did, and they were duped, then they can’t be expected to find fraud,” she says.

“If they didn’t, then they have problems.”

## **The Reach**

U.S. public company board members may take comfort in the notion that EY's tangle with Wirecard seems to be limited to the auditor's German member firm. EY Germany, however, signs off on audit opinions for four companies listed on U.S. exchanges, **Francine McKenna** reports in the *FT*. Those include **Centogene, BioN-Tech, Trivago** and **Orion**.

EY Germany additionally participates in the audits for numerous global U.S. companies, audit and accounting newsletter *The Dig* and PCAOB records indicate.

At **Expedia**, EY's Germany outfit did between 20% and less than 30% of the company's recent audit work, according to a regulatory disclosure. It did between 10% and less than 20% of the audit for **Archer Daniels**. And EY Germany did between 5% and less than 10% of the audits for **McDonald's** and **Texas Instruments**. (Audit committee members or company representatives from these companies either did not comment or declined to comment.) In toto, EY Germany participated in the audits of 30 U.S. companies, *The Dig* reported.

"You would have to be concerned about whether this is just an engagement partner, just an engagement team, or indicative of a larger issue," says Cox.

### **Stuck With the Status Quo?**

Beyond EY, the audit landscape has drawn considerable scrutiny in recent years. Criticism, for one, stems from conflict of interest concerns because the Big Four audit firms — KPMG, EY, **Deloitte** and **PwC** — have found lucrative business lines in non-audit services. In response, last week the United Kingdom's audit and accounting watchdog called on the four firms to separate their audit businesses by mid-2024.

Some see it as unlikely that regulators and others would act to seriously threaten the survival of any one of the Big Four. Indeed, given the already limited choices, there is likely to be hesitation at the idea of shrinking the group, says the audit committee chair. "Even if there were dramatic concerns with the audit quality at any one of these firms," the director says, "from the **SEC** and the PCAOB to public companies, audit committees and CFOs, I would expect a real reluctance for there to be less than four major global auditing firms."

Audit committees indeed have little in the way of other options if they are displeased that their auditor is mired in scandal, points out **Daniel Tesson**, professor of accounting at the **Rochester Institute of Technology** and an audit committee member on several privately held boards. "You can't name one of them that hasn't dealt with issues similar to

what we're seeing in the EY/Wirecard relationship," he says. Just last year, KPMG entered into a \$50 million settlement with the SEC related to a scheme in which audit professionals were claimed to have cheated on internal exams, as *Agenda* has reported.

What's more, a scandal may not lead companies to change firms, according to McKenna, a journalist and former audit professional. On a recent podcast episode, she described academic research she is working on that suggests that companies largely did not leave KPMG following the test-cheating scandal. Faced with limited choices and up against the time and cost constraints that stem from switching firms, audit committee members may opt to stay put. But Scaccetti rejects these as reasons to stick with a firm that does not instill confidence in the work.

The largest four firms use technology and widely accepted procedures, she says, so it is not as though the services offered by one auditor will vary drastically from the experience at another. "It's not without some indigestion as to getting used to sort of sitting in a new place and talking to new people."

"But I think management makes way too big a deal out of changing auditors, especially when you're talking about the caliber of one Big Four firm [compared] to another," Scaccetti says. "And I resist that."

*Agenda is a copyrighted publication. Agenda has agreed to make available its content for the sole use of the employees of the subscriber company. Accordingly, it is a violation of the copyright law for anyone to duplicate the content of Agenda for the use of any person, other than the employees of the subscriber company.*

An Information Service of Money-Media, a Financial Times Company