Do Client Business Scandals Affect the Reputation of Audit Firms?

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Màlaga
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INTRODUCTION
Introduction

Services Provided by Audit Firms

Audit Services

Non-Audit Services (NAS)

Other Assurance Services

Tax Services

Other NAS
Introduction

Demand for Audits

- Information asymmetries between management and owners
- Audits as a means to increase trust in financial statements
- Requirement: high quality of audits
Introduction

ISA 200.5

„The auditor is required to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.“

≠

Absolute level of assurance
Introduction

Auditing as a credence good

Information asymmetries between auditor and auditee/shareholders

- Auditing is a credence good
  - Clients are unable to assess important aspects of the service even after the purchase

→ ↑ relevance of audit firm reputation
THE ENRON SCANDAL
The Enron scandal

- Energy trading company
- America's 5th largest company
- „cooking the books“ → hidden debt, misrepresented earnings
- Summer 2001 → markets and regulators started to question the company
- Stock price fell from $ 90.75 to $ 0.26
- December 2, 2001: Enron declared bankruptcy
- Executives were sentenced to prison
The Enron scandal

- Arthur Andersen was Enron’s auditor
- One of the Big 5 audit firms
- 2000: $ 25 m audit fees
  $ 27 m consulting fees
- Arthur Andersen was accused of applying reckless standards in its audits
- January 17, 2002: Arthur Andersen was dismissed as Enron’s auditor
- June 15, 2002: Arthur Andersen was found guilty of shredding relevant documents
- August 31, 2002: Arthur Andersen surrendered its license
- Loss of customers, operations ended, 85,000 employees lost their job
- 3 years later, the conviction was overturned by the US Supreme Court
- However, the firm was deeply disgraced
DRIVERS OF AUDIT QUALITY
Drivers of audit quality

Insurance hypothesis

- Litigation risk
  → incentives for high audit quality

- Doubt about the ability of the auditor to provide such insurance
  → negative effects on the valuation of audit clients by investors

Reputation hypothesis

- Reputation for high audit quality
  → ability to gain new clients, retain existing ones, and charge high audit fees

- Doubts about audit quality
  → ↑ perceived investment risk → investors charge a higher risk premium
  → negative effects on the valuation of audit clients by investors

→ In a US setting, isolation of reputation hypothesis difficult!
Drivers of audit quality

Auditor liability in Germany

Liability to the client

- Intentional misconduct: unlimited
- Negligent misconduct: limited to € 1 m/4 m

Liability to third parties

- Intentional misconduct: unlimited
- Negligent misconduct: only in specific situations, e.g. personal contact between auditor and third party; liability cap applies

→ Intention is frequently not given and hard to prove
→ Liability exposure limit
→ Insurance hypothesis can be neglected
→ Germany is an ideal setting to analyze reputation effects
RESEARCH APPROACH
Research question

Do business scandals impact the reputation of the incumbent audit firm?
Measuring reputation effects

Market model

- Calculating coefficients for each client $i$

  \[ R_{i,t} = \alpha_i + \beta_i \cdot R_{i,m,t} + e_{i,t} \]

- Calculation cumulative abnormal returns for each client $i$ in event window $t = [\tau, T]$:

  \[ CAR_i = \sum_{t=\tau}^{T} e_{i,t} = \sum_{t=\tau}^{T} R_{i,t} - (\alpha_i + \beta_i \cdot R_{i,m,t}) \]
Responsibilities of the auditor

**Irregularities**

- Material misstatements of the financial statements
  - Error
  - Fraud
    - Fraudulent financial reporting
    - Asset misappropriation and non-compliance with laws and regulations
  - To be disclosed in auditor’s report

**ISAs 240 and 250**

- No influence on financial statements
  - Non-compliance with laws and regulations (on purpose or not)
  - To be disclosed in the report to those charged with governance

Auditor responsibility
EMPIRICAL RESULTS
Frankfurt-Hahn Airport case

- Built 1951
- US military airport
- 1993: end of military use
- Ownership: 87.5% Rhineland-Palatinate
  12.5% Hesse
- High debt: € 132.8 m
- December 2014: Rhineland-Palatinate decided to sell its shares to a private investor through a public tender
- KPMG was engaged
Frankfurt-Hahn Airport case

- June 6, 2016: Shanghai Yiqian Trading Company chosen as buyer
- June 7, 2016: Press releases doubted the existence of SYT
- June 29, 2016: TV report revealed that there is a tire trader at the SYT address and that defrauded shareholders often pass there; Rhineland-Palatinate suspended the sale
- July 5, 2016: A state secretary and KPMG representatives were send to Shanghai
- July 6, 2016: Sale was stopped; allegations that KPMG received falsified documents
  - Rhineland-Palatinate: KPMG did not conduct due diligence properly
  - KPMG: obligation of confidentiality
- Fee: € 6.25 m
- March 1, 2017: Sale of Rhineland-Plalatinate shares to HNA Airport Group
Frankfurt-Hahn Airport case

Timeline of Frankfurt-Hahn Airport case

- Existence of buyer doubted
  - 2016
- Sale questioned
  - 7.6.
- Sale discontinued
  - 29.6.
- 7.7.
## Results of the market model

<table>
<thead>
<tr>
<th>Scandal</th>
<th>Event Window</th>
<th>Expectation</th>
<th>N</th>
<th>$\bar{\Phi}$ (median) $\text{CAR}$</th>
<th>$t$-statistics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Frankfurt Hahn Scandal</td>
<td>Event 1 (7.6.2016)</td>
<td>–</td>
<td>67</td>
<td>-.057% (-.405%)</td>
<td>-.167</td>
</tr>
<tr>
<td></td>
<td>(-1;1)</td>
<td></td>
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<tr>
<td></td>
<td>Event 2 (29.6.2016)</td>
<td>–</td>
<td>70</td>
<td>.147% (.078%)</td>
<td>.315</td>
</tr>
<tr>
<td></td>
<td>(-1;1)</td>
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</tr>
<tr>
<td></td>
<td>Event 3 (7.7.2016)</td>
<td>–</td>
<td>73</td>
<td>-.499% (-.750%)</td>
<td>-1.336*</td>
</tr>
<tr>
<td></td>
<td>(-1;1)</td>
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</tbody>
</table>

**Notes:** *, **, and *** denote significance at the 10%- ,5%- , and 1%-level, respectively, of a one-tailed $t$-test of the hypothesis that the average CAR is less than 0 (more than 0), where the expected sign is $-$ ($+$). In the column event window, the first (second) number is the beginning (end) of the event window; 0 denotes the day of the event, while negative (positive) figures denote the number of days before (after) the day of the event.
Frankfurt-Hahn Airport case

Discussion

Overall, no reputation effect found

- Non-audit service
- Small engagement
- Public-sector company
- KPMG culpability unclear
Schlecker case

- 1975: foundation of a drugstore chain

**Bankruptcy**

- January 23, 2012: claim to start insolvency proceedings
- March 28, 2012: start of insolvency proceedings
- June 1, 2012: decision to break up the company
- June 27, 2012: stores were closed
- June 28, 2012: insolvency administrator announces end of the company
Schlecker case

Court case against family

- March 6, 2017: Court case started
- November 27, 2017: Court decision
  - founder Anton Schlecker 2 year imprisonment on probation, fine (intentional bankruptcy)
  - his kids Lars/Meike, imprisonment of 34/35 months (delay in filing for insolvency; breach of trust and fraud)
Schlecker case

Court case against auditors

- 2 auditors from EY were accused that they detected the manipulations in the financial statements but nevertheless provided a clean opinion
- April 14, 2016: indictment against auditors
- April 25, 2017: proceedings against EY auditors is separated from proceedings against family
- May 23, 2017: closing of court proceedings against the imposition of a fine due to minor fault
Schlecker case

Timeline of Schlecker case

- 14.4. 2016: Suit
- 23.5. 2017: Suit separated
- 25.4. 2017: Suit discontinued
# Schlecker case

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<th>t-statistics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Schlecker Fraud</td>
<td>Event 1 (14.4.2016)</td>
<td>−</td>
<td>56</td>
<td>-1.474% (-1.373%)</td>
<td>-2.746***</td>
</tr>
<tr>
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<td>(-1;1)</td>
<td></td>
<td></td>
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</tr>
<tr>
<td></td>
<td>Event 2 (25.4.2017)</td>
<td>+</td>
<td>59</td>
<td>.143% (.114%)</td>
<td>.359</td>
</tr>
<tr>
<td></td>
<td>(-1;1)</td>
<td></td>
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</tr>
<tr>
<td></td>
<td>Event 3 (23.5.2017)</td>
<td>+</td>
<td>58</td>
<td>1.862% (1.003%)</td>
<td>3.561***</td>
</tr>
<tr>
<td></td>
<td>(-1;1)</td>
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Schlecker case

Discussion

Audit service

- Bankruptcy case = directly related to financial statements audit
- Clear reputation effects
Volkswagen dieselgate case

Illegal manipulations of diesel cars to comply with emission limits

- September 18, 2015: scandal becomes public

Consequences in Germany

- October 8, 2015: raid to secure data
- November 11, 2015: PwC is accused of neglect and lack of independence by brief inquiry of party „Die Linke“
- November 24, 2015: investigation extended → tax fraud
- June 2016: investigations because of missing ad hoc publicity
- Ongoing claims for damages by customers
Volkswagen dieselgate case

Consequences in the US

- January 11, 2017: settlement in US: $ 2.8 bn criminal penalty + $ 1.45 bn civil penalty
  commitment to stronger control systems
  external supervision for 3 years
  Investment of $ 2 bn in a charging pole network, accessible to all cars

- Payments of $ 7,000 - 16,000 to customers

- Imprisonment of employees
Volkswagen dieselgate case

Timeline of Volkswagen dieselgate case

2015

18.9.
VW Scandal gets revealed

Brief inquiry accuses PwC

6.11.
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<th>t-statistics</th>
</tr>
</thead>
<tbody>
<tr>
<td>VW Scandal</td>
<td>Event 1 (18.9.2015)</td>
<td>-</td>
<td>72</td>
<td>.677% (.624%)</td>
<td>1.606*</td>
</tr>
<tr>
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<td>(-1;1)</td>
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</tr>
<tr>
<td></td>
<td>Event 2 (6.11.2015)</td>
<td>-</td>
<td>72</td>
<td>.072% (.090%)</td>
<td>.184</td>
</tr>
<tr>
<td></td>
<td>(-1;1)</td>
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Volkswagen dieselgate case

Discussion

Audit service

- Offense cannot be detected during financial statements audit
- No reputation effects
Siemens case

General

- One of the world’s leading electronics company
- Conglomerate
- Market value $\approx € 100$ bn
- Employees $\approx 380,000$
- Profit $\approx € 6$ bn
Siemens case

Corruption Scandal

- 330 dubious projects
- 4,300 illegal payments, e.g. in South Africa, Argentina, Venezuela, China, Mexico, Nigeria, Russia, Egypt, Saudi-Arabia, Greece

- In total $\approx \varepsilon 1.3$ bn

$\downarrow$

- Cost $\approx \varepsilon 2.9$ bn
Siemens case

Corruption scandal

- November 15, 2006: police raid
  → imprisonments and resignations of many board members
- July 2007: total amount of bribe payments (€ 1.3 bn) announced
- October 2007: € 201 m penalty payment (Higher Regional Court)
- December 2008: settlement with US Department of Justice
  → $ 450 m penalty
  and with SEC
  → $ 395 m penalty

- Criminal convictions against former board members
- Settlements between Siemens and former board members
Siemens case

Neubürger case

- September 9, 2007: criminal investigation against ex-CFO Neubürger started
- Proceedings were closed in 2011 for a payment of € 400,000 to a charity
- Siemens sued him for damage compensation due to a breach of monitoring obligations
- November 2013: court decision: € 15 m
- Summer 2014: settlement between Siemens and Neubürger
- February 2015: suicide

→ Board members are liable in case that they do not set up an adequate compliance management system

Effect

Siemens now has a highly developed CMS: „only clean business is a Siemens business“
Siemens case

The auditor (KPMG)

- November 17, 2006: police raid at KPMG offices
- December 3, 2006: media reports about the police raid
- September 21, 2007: Siemens supervisory board members plan to investigate why auditors did not find suspicious payments
- December 3, 2007: Siemens supervisory board decides to replace KPMG after 2008
Siemens case

Timeline of Siemens case

2006
3.12. RAID at KPMG

Volume known

2007
11.12. Volume known

21.9. Siemens replaces KPMG

Board investigates KPMG

3.12.
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<tr>
<td>Siemens Scandal</td>
<td>Event 1 (3.12.2006)</td>
<td>–</td>
<td>63</td>
<td>-.743% (-.654%)</td>
<td>-1.912**</td>
</tr>
<tr>
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<td>(-1;1)</td>
<td></td>
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<tr>
<td></td>
<td>Event 2 (11.12.2006)</td>
<td>–</td>
<td>65</td>
<td>-.344% (-.377%)</td>
<td>-.994</td>
</tr>
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<td>(-1;1)</td>
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<td></td>
<td>Event 3 (21.9.2007)</td>
<td>–</td>
<td>65</td>
<td>-.576% (-.702%)</td>
<td>-1.126</td>
</tr>
<tr>
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<td>(-1;1)</td>
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<tr>
<td></td>
<td>Event 4 (3.12.2007)</td>
<td>–</td>
<td>64</td>
<td>1.155% (.372%)</td>
<td>1.965**</td>
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<tr>
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<td>(-1;1)</td>
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Siemens case

Discussion

Audit service

- Bribery payments in income statement
- Auditor potentially might reveal bribery payments
- Negative reputation effect (first event)
- Positive impact (fourth event) surprising
Conclusion

- Reputation is essential in the audit industry
- No spillovers from non-audit services on audit quality reputation
- Business scandals can threaten the reputation of the involved auditor
- Negative impact of financial statements fraud
- Other offenses: Can they be revealed by the audit?

Limitations:
  - Germany
  - Small sample
  - Just four cases
  - Completeness of events
  - Timing of events