Wirecard has clearly illustrated what can happen if the three lines of defence – Internal Control System, good corporate governance incl. a strong Supervisory Board and the external audit fail to perform. This is a major issue if you look at the amount of money – 20bn EUR – lost for investors.

It was not the auditor detecting the fraud – it was journalists from the FT pointing to allegations of fraud already in 2015!

And Wirecard is not the only reporting failure:

All of the Big Four firms (as well as the firms in the next tier down) have been rocked by scandals: The PCAOB, the oversight body for auditors in the US found significant high failure rates: In the most recent figures available, inspectors found Deloitte and EY got one in five audits wrong, PwC almost one in four, and KPMG even every second audit. And all four firms had worse records in their latest spot checks than when the PCAOB first began inspecting audits in 2004. Or check "Accounting scandals" at Wikipedia: All of the Big Four accounting firms had been auditing companies involved in accounting scandals over the last 10 years.

Statutory auditors in theory are there to identify and assess risks of material misstatements in financial statements and publicly report on their findings. They are entrusted with a public interest task and especially shareholders rely on their reports. This means that if we cannot be sure that auditors are doing their job properly and that shareholders can rely on their signature, we have a significant problem.

The question is what needs to be done to reduce the incidence of audit failures?

Let‘s look at the status quo in EU first:

Audit Reform after financial crisis.

The aim: improving statutory audits by reinforcing auditors‘ independence and their professional scepticism through:

- Prohibition of (certain) non-audit services
- Introducing a mandatory external rotation
- Extending the reporting obligations (audit report to include key audit matters)

Results of the reform 2 years after?

Beginning of 2021: Monitoring Report of the EU Commission on the EU audit market for PIEs which revealed some interesting findings:

- 10% less auditors

- 35% less audit firms auditing PIEs
- 9% increase in audit firms turnover (statutory audits)
- Big Four still dominate the audit market (66% of PIE statutory audit market, 90% of total audit firms turnover with PIEs)
- NCAs highlight deficiencies in audit firms internal quality control systems: Audit supervisers found problems with internal quality control systems and a lack of or inappropriate monitoring of high-risk audited entities and insufficient audit evidence and documentation

– still outstanding: EU study on te application of the audit directive and audit regulation which is expected to be ready in September 2021.

What are the reasons for this lack in quality? The oligopoly of the big 4 which hinders competition? The lack of independence of auditors? The lack of liability? Or the lack of supervision?

Regulators and lawmakers tried a lot to break up the oligopoly of the Big 4 that have been hit by scandals but so far, all measures failed. So what is the way forward?

I think we need to improve the audit profession in 4 areas:

- The quality of the auditor's work
- Auditor's competition
- Auditor's independence and
- Auditor's liability

Quality of the auditor's work:

The first element which guarantees that an auditor can properly exercise his role, is the access to the necessary information. A lack of information easily becomes a lack of control. In the Wirecard case it is obvious that auditors encountered issues in getting required information and data, including from third parties. In order to help the auditors to fully exercise their mission, auditors' right to information, in particular from employees, need to be fostered and confidentiality agreements need to be adapted.

Auditor's competition:

First, we need to add a cooling-off period to the internal and the external audit rotation requirement. It doesn't make much sense to ask for a mandatory audit rotation and then allowing audit firms to re-join the company after one or two years. This is part of good corporate governance for former executives and should be introduced for audit firms as well.

Another idea, not new, because existing already in certain MS, like France, is the requirement of a joint audit. It could have several advantages, in particular in light of the Wirecard scandal: i) two audit firms have to agree on the audit work and conclusions; ii) it is more difficult for the company management or board to influence two audit firms than one; iii) the liability in case of wrongdoing is split into two, which would also improve the reparation prospects of the victims. It also however has disadvantages: on the one hand there is an increase in costs for companies and thereby for shareholder. In addition, joint audits do not necessarily break up the oligopoly of the big four: Currently, only those seem to be capable to perform a full audit for a company like eg. Deutsche Bank – no wonder that they had KPMG for more than 100 years. I therefore favour the idea of a shared audit where a second auditor is appointed to conduct parts of the audit services and may challenge the lead auditor on specific parts of the audit with his/her expertise. This in my view would help smaller audit firms to enter the market and would still enable a four eyes view on certain sensitive parts of the business.

Auditor's independence:

This is the most crucial part of the game. You will well remember the Volkswagen case – the Diesel scandal a couple of years ago. This had less to do with wrong accounting but Volkswagen in the aftermath of the scandal had restricted the information flow to shareholders severely. They conducted an investigation of the scandal and never disclosed the results to shareholders who lost a lot of money and needed information on who was responsible for the scandal to try to get compensated. DSW therefore initiated a special audit to reveal such information. We asked numerous audit firms to perform such a special audit for us and the big four but also many other, smaller audit firms rejected because they were conflicted as they were performing services for Volkswagen. We finally found a firm and the special audit is still ongoing but as you can see, if shareholders are not able to find an independent auditor to help them to exercise their rights, something is severely wrong in the market.

What needs to be done to increase auditor's independence?

Firstly, auditors need to be required to act exclusively as auditors – no more non-audit services should be allowed. This is a very puristic approach but in my view, the distraction of non-audit services needs to be removed.

Secondly, we need to eliminate the major conflict of interest an auditor has by proposing fundamental changes in who pays for audits. Currently, auditors are paid by the entity that needs to be audited. The fact that auditors' responsibility is to the shareholders of the audited company although they are paid by the audited company creates a distortion within the system. The audit role should be one of statutory inspection wherein the proposal for appointment, the remuneration and the duration of the engagement would be the responsibility of a third party, perhaps a regulator, rather than the company itself. The appointment itself should remain with shareholders, though, as the owners of the company. Such a concept may be especially relevant for the audit of the financial statements of large companies and/or systemic financial institutions. This matter should be explored, taking into account, on the one hand, the risk of increased bureaucracy and, on the other hand, the possible societal benefits of demonstrably independent appointments. The only problem is whether it is feasible: this proposal had been made by Michel Barnier when the COM kicked off the last audit reform in 2010 and failed miserably in the legislation process…

Turning to auditor’s liability which needs a reform, too:

First, we need a European collective redress mechanism for shareholders. The EU has created an instrument for consumers and for indirect investors, meaning fundholders or holders of ETFs but there is no such thing for shareholders. Looking at the Wirecard case again, this means that shareholders do not have a tool available against the only remaining party in the game the auditor, that would be able to compensate their losses resulting from fraudulent behaviour and non-detection by auditors. But even if they had, they would not have a chance to be compensated: Wirecard is insolvent, their directors do not have enough money and the auditors in Germany currently have a liability cap of 4m EUR – this has been raised to 16m EUR for cases of ordinary negligence but this is still far from being enough especially as the burden of proof of course lies with the damaged shareholders. Lifting the liability cap for audit firms and introducing a personal liability for audit partners are therefore also ideas that need to be explored.

Last but not least, from my perspective there is also a need for more accountability of auditors towards shareholders: auditor’s reports today consist of standardized phrases that are overall meaningless for investors. Key audit matters have improved the situation. A further tool could be to strengthen the auditor’s position by enabling him to explain himself at the AGM and allow shareholders to question him.

Let me conclude: There is a true lack of quality among audit services. The audit reform 2014 has not yet delivered to improve the service quality or enhanced competition. We therefore need stronger action to improve the audit competition, auditor’s independence and auditor’s liability.