THE BIG 4 ACCOUNTING FIRMS:

CLIENTS INTEREST / PUBLIC INTEREST/CORPORATE INTEREST
WHO ARE THEY SERVING?

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Rights & Responsibility Event – Amsterdam – March 7, 2019

SUSTAINABLE VALUE INVESTORS

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FOREWORD

In the following slides, we present a collection of articles about major controversies involving the Big 4, which were pubblished in the Financial Times in 2018 and early 2019.

A succession of scandals in major companies audited by the Big 4 in the UK, South Africa, etc. accompanied by high losses by institutional investors, prompted a debate, particularly in the UK and in Holland about the level of conflicts of interest and how to restore public trust in auditing.

As of March 2019, the current ESG Reputational Risk (as calculated by the ESG service provider RepRisk) of the Big 4 was HIGH RISK for KPMG and PWC and MEDIUM RISK for E&Y and Deloitte.

For further information, kindly contact: info@sustainablevalueinvestors.com

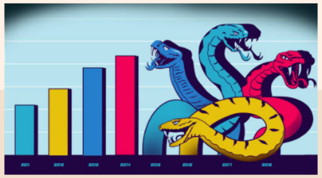
FT SURVEY:SUMMARIZING THE MAJOR ISSUES

The incestuous ties that bind auditors and watchdogs

Concerns that audit market is too beholden to the clients whose numbers it vets

An illusion of choice: the conflicts that mire the audit world

Most listed US and British groups use one of the Big Four, with issues discreetly hidden



The big flaw: auditing in crisis

FT series: with a cabal of auditors dominating the market and chiefs making most of the system of ‘fair value’, what can the industry do to raise standards?

Reform accounting rules to restore trust in audit

Prudence and judgment were lost in the drive to fair value standards

COMBINED DATA OF THE BIG 4

Heating up

$134bn

Combined revenues of the ‘Big Four’ auditors. They employ 945,000 people

$2.9tn

Total goodwill on balance sheets of S&P 500 companies in 2016, up from $1.8tn in 2007

60%

Remuneration based on equity for CEOs at S&P 500 groups in 2014, up from 25% in 1992

ACCOUNTING FINES ISSUED IN THE US AND UK

From a Big Eight in 1987, the industry consolidated to a Big Five by 1998. With the collapse of Arthur Andersen in 2002, their number shrank to four. These firms entirely dominate the markets for auditing quoted companies in the UK and the US. Many observers accept this lack of choice makes the industry difficult to regulate. "It makes the Big Four too big to fail," says Guy Jubb, an honorary professor at the University of Edinburgh and a corporate governance expert.

Accounting fines issued

Source: Thomson Reuters
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Last year the quartet had combined revenues of about $134bn, employing almost 945,000 people, according to Statista. Scale makes the Big Four much more of a target for shareholder litigation, especially in the US.

INCREASED SCRUTINY IN THE UK

More recently, it is behind a string of accounting scandals involving overstatements of profit, including at the UK supermarket chain Tesco and the software company Quindell. It hangs over the insolvency of the UK outsourcing group Carillion, where sudden contract restatements in 2017 erased the previous six years of dividend-bearing profits. In the US, the conglomerate GE is under investigation over the way it accounts for its contracts.

These events have fuelled concerns about the auditing market, and whether the Big Four accountancy firms— KPMG, Deloitte, EY and PwC — are too big to fail, too profit-driven and excessively compliant to managers' wishes. Britain has started an investigation into the effectiveness of its auditing regulator, the Financial Reporting Council.

But this may be looking at the symptoms rather than the cause of the problem. That may lie in the accounting standards themselves.

THE MOST RECENT CASE IN THE UK

PwC accused of ignoring conflicts over Staffline audit

Questions raised over links between firm and recruitment group hit by accounting row

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Madison Darbyshire and **Madison Marriage** MARCH 4, 2019

PWC AND STAFFLINE: CONFLICTS OF INTEREST

Mr Watts was appointed Staffline's finance director in January 2018. He qualified as a chartered accountant with PwC, where he worked until 2002. Mr Barker, a non-executive director at Staffline and chairman of its audit committee — who is separately finance director of retailer Superdry — worked as an audit manager at PwC from 1995 until 2001.

Meanwhile, Mr Ledgard, the company's finance director until 2016, was a PwC qualified accountant.

SOME OF THE CASES

The close ties between corporate boards and auditors has been increasingly scrutinised in recent years following a series of high profile accounting scandals. These include controversies involving KPMG's audit work for South Africa's Gupta family and PwC's audit work for British retailer BHS.

JOHN PLENDER OF FT ON BIG 4

The Big Four face the dismembering of accountancy's cosy club

After Carillion, there can be no more undervaluing of the poor relation audit

JOHN PLENDER ✓ Added

John Plender MAY 18, 2018 — 76

Big Four scandals highlight a lack of social utility

A series of issues around the world shows all too clearly that auditing has become flabby

JOHN PLENDER ✓ Added

The Big Four of Deloitte, EY, PwC and KPMG are responsible for auditing the vast majority of the world's largest companies

John Plender AUGUST 6, 2018 — 57

THE MAIN ISSUES WITH THE BIG 4

Part of the trouble is that the big firms have reneged on an implicit contract. External audit is a statutory requirement in company law. In exchange for this guaranteed market accountancy firms are expected to give the highest priority to providing robust audits.

The other important contributory factor to weak audits is a change in professional ethos. Today's Big Four are financial services conglomerates in which conflicts of interest can arise. Winning lucrative new consultancy business is prized more highly than ensuring the integrity of unexciting, low-margin audit. And they have the luxury of knowing that since the demise of Andersen after the Enron scandal policymakers are terrified of the Big Four becoming the Big Three. Like the big banks they have become too big to fail.

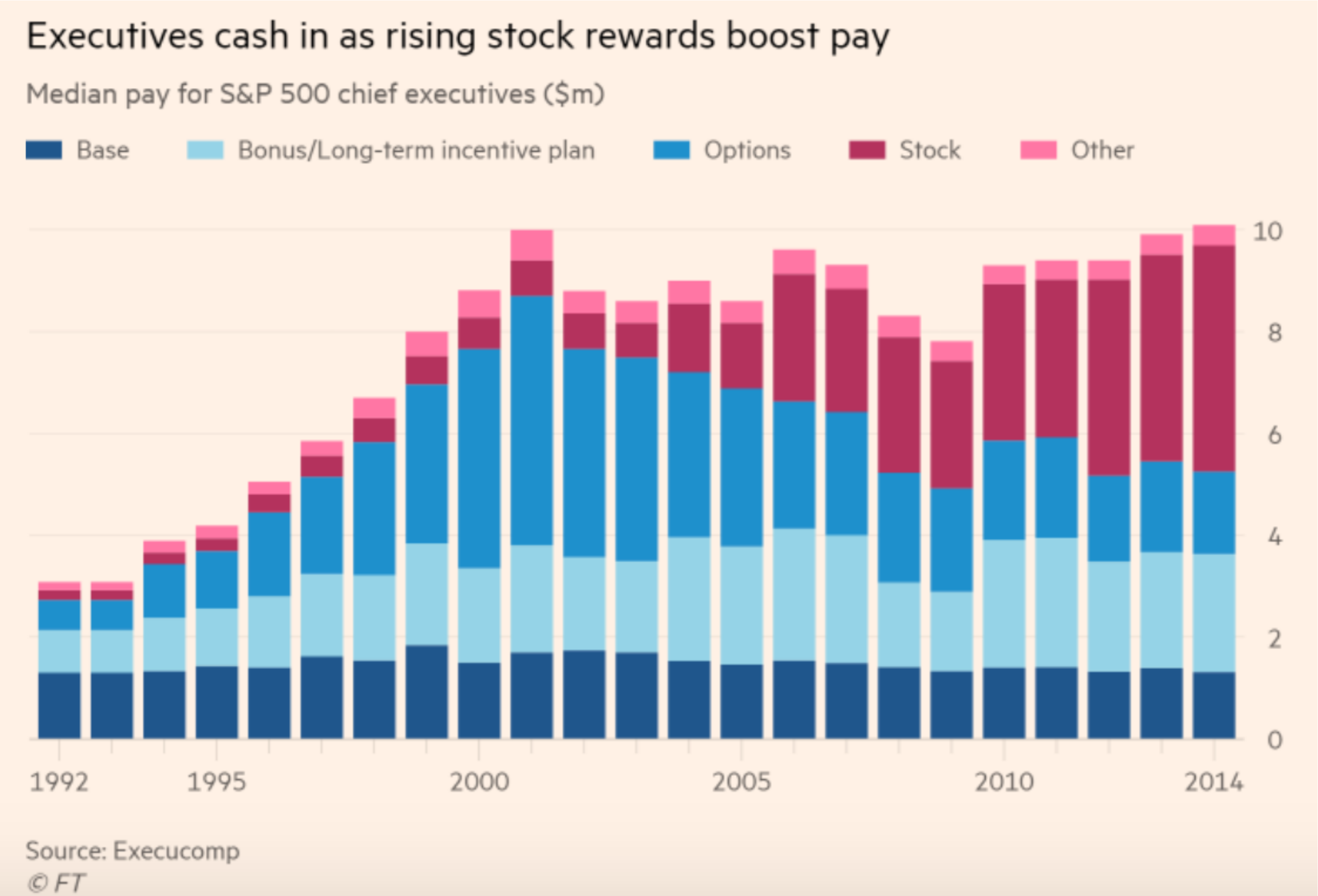
IFRS ACCOUNTING STANDARDS – FAIR VALUE

From the 1990s, fair values started to supplant historical cost numbers in the balance sheet, first in the US and then, with the advent of IFRS accounting standards in 2005, across the EU. Banking assets held for trading started to be reassessed regularly at market valuations. Contracts were increasingly valued as discounted streams of income, stretching seamlessly into the future.

This was also a time when managers' pay, especially in the US, was rising through the use of market-linked incentives. Between 1992 and 2014, equity-based pay at S&P 500 firms rose from 25 to 60 per cent of their total remuneration, according to database ExecuComp.

It did not take long for bosses to perceive the pecuniary possibilities of their ability to influence fair values. Between 1995 and 1999, for instance, Enron's stock underperformed the S&P 500 index. Yet in 2000, when the US energy company's accounting chicanery started to kick in, its shares wildly outperformed the benchmark. In the 10 months before its collapse, the company paid out $340m to executives.

MEDIAN PAY FOR S&P 500 CEOS



INSTITUTIONAL INVESTORS AND POLICY MAKERS SCRUTINY

The blame should not be shouldered exclusively by the auditors. Institutional investors around the world have undervalued the audit function and played a minimal role in the policy debates around fair-value accounting and in the standard-setting process. In taking such a casual approach to the data that define corporate performance they have seriously failed beneficiaries such as pension scheme members.

For their part policymakers have been too susceptible to lobbying by the Big Four. And they hesitate to engage with technical accountancy questions. In the light of the unending succession of scandals that really has to change if public trust in auditing is to be restored.