

SEC Accountant Warns of Heightened Fraud Risk Amid Recession Fears, Market Selloff

Auditors need to do a better job uncovering accounting manipulation, regulator says

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Wall Street's top watchdog is warning that the market selloff and fears of a recession could encourage more companies to cook their books, and it is pressuring auditors to catch them.

"The current economic environment is subject to significant uncertainties and, historically, that oftentimes leads to heightened fraud risk," Paul Munter, acting chief accountant at the Securities and Exchange Commission, said in an interview. "So we are trying to be proactive and speak to the marketplace."

The warning comes as regulators increase their scrutiny of auditors. The audit regulator is getting tougher on rule-breaking accountants. Big fines for auditors are part of record monetary sanctions imposed by the SEC in the latest fiscal year.

The SEC is concerned that auditors too often fail to respond adequately to red flags that point to possible financial chicanery, Mr. Munter said in a statement last month. Regulators' inspections of audits "consistently identify areas of concern involving auditors' application of due professional care and professional skepticism when considering fraud," the statement said.

Auditors say they are following the law, which limits their responsibility to root out frauds. They get frustrated by the public backlash when they fail to catch companies deliberately manipulating financial statements.

"We are not set up to look for fraud," David Dunckley, chief executive of audit firm Grant Thornton UK, told British lawmakers in 2019. "We are not giving a statement that the accounts are correct. We are saying they are reasonable."

The SEC's Mr. Munter said in his statement it is "particularly troubling" when auditors focus on what they aren't required to do, which could reduce the likelihood of detecting

fraud. He wanted to send a “very strong reminder to audit firms” about their responsibilities, he said in the interview.

A spokesman for Grant Thornton declined to comment.

The issue of auditors’ responsibility is playing out globally, including in multibillion-dollar lawsuits against Ernst & Young going through the courts in Germany and the U.K. The firm is accused of failings in its audits of two corporate blowups, fintech company Wirecard AG and hospital operator NMC Health PLC.

In a U.K. filing last month responding to a \$2.7 billion claim for damages related to NMC Health, EY said its audits are designed to give reasonable, rather than absolute, assurance the financials aren’t materially misstated. The primary responsibility for the accuracy of those statements rests with the company, EY’s filing said. It added that the alleged fraud involved falsification of documents.

After coming under fire for its role in Wirecard and other corporate failures, EY two years ago told clients it was taking a number of steps to more actively look for big frauds.

Those measures have “led to the detection of fraud” in several cases, said David Kane, EY global vice chair professional practice.

Ernst & Young has told clients that it was taking steps to more actively look for big frauds. Photo: Frank Hoermann/Sven Simon/Zuma Press

The firm is using artificial intelligence to parse ledgers for suspicious transactions, mining social-media posts and using forensic-accounting specialists earlier to look for potential accounting violations at high-risk companies, Mr. Kane said. EY is turning away more potential audit clients and discontinuing working for a higher number of existing clients than in the past, he added.

Such measures by EY and other accounting firms don’t overcome the basic conflict of interest in the industry: Accounting firms are paid by the companies they audit, making it less likely they will confront bad behavior.

Worries that auditors can buckle under client pressure to sign off on suspicious financial statements go back decades. In the run-up to the 2001 collapse of Enron Corp., a partner at its now-defunct auditor Arthur Andersen complained that his advice against certain accounting practices was being ignored. The partner was later removed from the Enron audit team, following complaints by an executive of the Houston-based energy company.

Some accounting industry insiders say little has changed since then. Sayantani Ghose, a tax expert and former EY employee, filed a lawsuit against EY in September claiming she was punished for flagging concerns about potential fraud by two big audit clients in 2020.

Ms. Ghose said in her lawsuit that she questioned whether the two clients were using intercompany transactions to illegally reduce the amount of tax owed. She alleged that EY overrode her objections, in one case removing her from the account in favor of “an auditor who would rubber-stamp” the client’s approach. Ms. Ghose was fired by EY in January and is now working for another Big Four firm, public records show.

“EY’s public stance that its reviews of financial statements are independent of any client pressure does not match the reality of working for the firm,” Michael Willemin, Ms. Ghose’s lawyer, said.

An EY spokesman said the firm would aggressively defend itself against Ms. Ghose’s “baseless” claims, which were “dismissed in their entirety” by the Labor Department after she submitted a whistleblower claim.

Mr. Willemin said that the lawsuit will look at evidence that wasn’t considered in the earlier ruling, such as EY internal documents and witnesses.

After Ms. Ghose filed her lawsuit, she was contacted by other EY employees who said they had also come under pressure for raising concerns during audits, Mr. Willemin said.

The EY spokesman said “all our people are encouraged to voice any concerns in performing their professional obligations, without fear of reprisal or retaliation.”