Researchers find evidence of added auditor scrutiny involving credit default swaps

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Institutions that monitor public companies include governments and regulators, financial media, analysts, shareholders, debtholders and auditors. A forthcoming paper that includes two University of Kansas School of Business professors suggests that reduced monitoring incentives among bondholders lead to increased monitoring efforts by auditors.

Adi Masli, Felix Meschke and KU graduate Lijing Du, who is now an assistant professor at Towson University, provide evidence that auditors increase their professional scrutiny of companies when it becomes easier for the debtholders of those firms to insure against loss via credit default swaps, or CDS.

"The results suggest a substitution effect," said Meschke, associate professor of finance. "Because CDS-insured debtholders lack incentives to monitor or make concessions if firms become financially distressed, auditors seem to increase their own monitoring effort, which is reflected in higher audit fees."

The researchers find that audit fees increase between 5.4 percent and 11 percent for companies with CDS-referenced debt. Their study is forthcoming in *Auditing: A Journal of Practice & Theory*.

Credit default swaps are financial instruments that insure against default of a bond. If the issuer of a bond fails to pay lenders, CDS buyers receive money from the seller of those instruments. Banks, hedge funds or large insurance companies like AIG sell credit default swaps.

In fact, many people associate credit default swaps with the 2008 financial crisis and the government bailout of AIG, Meschke said. AIG had sold a large number of credit default swaps without properly hedging their risk, and during the subprime housing crisis, AIG lacked the funds to meet its obligations. The government took over control and bailed out the insurer with $180 billion.

Previous research shows how credit default swaps can distort the incentives of creditors. Ordinarily, lenders have incentives to monitor their borrowers to ensure that the borrowing firms act prudently and return the borrowed funds. If a borrower falls on hard times, it is often in the lender's best interest to make some concessions to help the borrower survive. Lenders who insure their debt through credit default swaps no longer have incentives to monitor borrowers or to help them survive in a crisis, the researchers said.

Some financial researchers have used the analogy of a heart surgeon taking out a life insurance policy on a patient with a $100 million payout to the surgeon if the patient dies. Such a contract creates an obvious conflict of interest for the surgeon.

"If creditors get paid in the event of a default, they do not need to discourage borrowing firms from taking undue risk. Insured creditors often prefer a quick bankruptcy to a drawn-out period of financial distress and have incentives to push distressed firms into bankruptcy to receive payment from the CDS seller," Meschke said.

The researchers identified 887 public firms in the United States that had traded CDS on their debt for at least one fiscal year between 2001 and 2015. They compared audit fees from those CDS-referenced firms with a control group of similar firms that had no traded CDS on their debt during that time.

"Credit default swaps that reference the debt of corporate clients should garner the attention of external auditors because these contracts can reduce creditors' monitoring and alter incentives in the restructuring process," said Masli, associate professor of accounting.

The researchers investigated several other explanations why audit fees are higher for companies with CDS-referenced debt and why audit fees increase once credit default swaps on a firm's debt become easily available. They found no evidence the CDS initiations and increases in audit fees were joint responses to deteriorating corporate conditions.

Meschke said another potential explanation for the higher fees could be that auditors associate CDS initiations with higher risk and therefore charge more to cover higher expected liability losses. However, the researchers note that CDS initiations themselves do not signal current or future increases in bankruptcy risk for firms in the sample.

The most likely explanation for the increase in audit fees, he said, is that auditors step up their monitoring efforts when the availability of credit default swaps allows debtholders to easily insure their debt and no longer monitor the borrowing firms.

"We cannot say that they are doing enough," Meschke said, "but they are doing something."

More information: Credit Default Swaps on Corporate Debt and the Pricing of Audit Services. papers.ssrn.com/sol3/papers.cf … abstract_id=2993474#%23

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