Depositors often blame audit firms for bank failure, study finds

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The word "audit" has a different meaning depending on whether you're an individual or a bank. But a perceived audit failure can have equally damaging consequences.

"We found that depositors—people who have money at banks—lose faith in an auditor when that auditor is associated with another bank that fails," said Matthew Beck, assistant professor of business at the University of Kansas.

His new article, "The Role of Audit Firms in Spreading Depositor Contagion," argues that depositors perceive bank failure as an audit failure, which reduces their assessment of auditor credibility. This leads to lower deposit growth at banks with the same auditor. It's published in *The Accounting Review*.

"Most deposits, like what you and I have in our bank account, are covered by insurance from the FDIC. That insurance right now covers up to $250,000. Our deposits are safe if the bank fails. However, there are depositors who may have larger amounts not covered by insurance and may lose their money if the bank fails. So they have a very strong interest in making sure their money is going to be safe," Beck said.

Depositors assess bank performance by examining their financial reports. And the way depositors become confident such reporting is accurate is to have an auditor come in and audit those financial statements.

"People often want liquid assets, and there might not be a better way than having money in a bank," he said. "Uninsured depositors also may get a higher rate of return on their money than you and I do with our savings accounts, as the bank is paying them a little bit more than it pays us to compensate them for that risk."

Beck, who co-wrote the article with Allison Nicoletti of the University of Pennsylvania and Sarah Stuber of Texas A&M University, said there's an expectation gap between what a financial statement audit really is versus what the public assumes it is.

He says that "a lot of times people think, 'Oh, this company got a clean or unqualified audit opinion and that means it's a good company, with good management, a good CEO.' But when you look at the actual opinion, all it says is, 'We're giving you reasonable assurance there are no material misstatements in the financial statements. That's it.'"

The impetus for this project came from the authors wondering aloud if an auditor would get blamed when a bank fails. When such an institution collapses, customers might need "a scapegoat to point their fingers at," he said.

His team took data sets from various banks, running multivariate regressions and using statistical analysis to find relationships between these two factors. This determined exposure to failure through the audit firm is associated with lower uninsured deposit growth, consistent with depositors perceiving this as a negative signal of auditor credibility. It also showed the results are stronger when awareness regarding the failure is greater, including when a larger bank is involved or when significant news coverage occurs.

Beck was surprised to learn while doing this research that not all banks get audited.

"You need to have over $500 million in assets at a bank in order for an audit to be required. Smaller banks—such as a single branch bank in a small town—may not be audited," he said.

Before going into academia, Beck worked as an auditor for KPMG (one of the "Big Four" firms) in Richmond, Virginia, and Prague, Czech Republic. The Chicago native is now in his fourth year at KU.

"Having an unstable banking system is a bad thing for the economy," Beck said. "Understanding that this sort of thing can happen is beneficial to know. It gives banks a chance to be proactive and tell depositors, 'Hey, a client of our auditors failed … but it had nothing to do with the audit.'"

More information: Matthew J. Beck et al, The Role of Audit Firms in Spreading Depositor Contagion, *The Accounting Review* (2021). DOI: 10.2308/TAR-2018-0381

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