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Financial crisis and the silence of the auditors

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ABSTRACT

Against the backdrop of the current financial crisis, this paper seeks to stimulate debates about contemporary auditing practices. It notes that many financial enterprises have sought state support within a short period of receiving unqualified audit opinion. Auditors collected large amounts in audit and non-audit fees. The events raise questions about the value of company audits, auditor independence and quality of audit work, economic incentives for good audits and the knowledge base of auditors.

Introduction

External audit is promoted as a trust engendering technology (Power, 1999) to persuade the public that capitalist corporations and management are not corrupt and that companies and their directors are made accountable. In an uncertain world, corporate audits are expected to produce comfort by reassuring the stakeholders that the technology "provides an external and objective check on the way in which the financial statements have been prepared and presented, and it is an essential part of the checks and balances required... Audits are a reassurance to all who have a financial interest in companies" (Committee on the Financial Aspects of Corporate Governance, 1992, p. 36).

Accountants, as auditors, have cemented their status and privileges on the basis of claims that their expertise enables them to mediate uncertainty and construct independent, objective, true, and fair accounts of corporate affairs. This expertise, it is claimed, enables markets, investors, employees, citizens, and the state to limit and manage risks. Such claims, however, are precarious as measures of revenues, costs, assets, liabilities, and profits are contested technically as well as politically and also because capitalist economies are inherently prone to crises (O'Connor, 1987). The claims of expertise are frequently punctured by unexpected corporate collapses, frauds, and failures. Such events fuel the suspicions that auditors lack the requisite independence, expertise and incentives to construct the promised 'true' and 'fair' account of corporate affairs. They also provide an opportunity to reflect and (re)construct the role of auditing in contemporary society.

At the time of writing (December, 2008), major Western economies are going through a deepening financial crisis, given visibility by banking failures and massive state intervention to rescue ailing financial institutions. Against the backdrop of increasing economic turbulence, this paper seeks to stimulate debates about the quality of auditing by examining the audit reports issued on the financial statements of distressed financial enterprises. It consists of three further sections. The next section contextualises the financial crisis and shows that a large number of enterprises have collapsed within a short period after receiving unqualified audit reports. Auditors also received large amounts of fees from distressed enterprises. The second section offers reflection on the role of auditors and suggests possible areas of research. The final section briefly summarises the paper.

Financial crisis and auditors

A salient feature of the current financial crisis is that it has been incubated by the financialisation of Western economies, most notably the US economy, which created an abundance of credit and encouraged excessive risk-taking through complex financial instruments (derivatives, credit default swaps) and corporate structures and

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ineffective regulatory mechanisms (Ferguson, 2008; Morris, 2008; Soros, 2008). Banks, hedge funds and insurance companies have been key actors in the financialisation of the economy and are estimated to have lost around US$2.8 trillion (Bank of England, 2008).

The social cost of the unfolding crisis is difficult to estimate, but vast amounts of public money are being used to prop-up distressed financial enterprises. For example, in addition to providing huge sums to stimulate banking liquidity, the UK government has set aside £500 billion (about US$750 billion) to support financial enterprises (The Guardian, 8 October 2008). It has closed London Scottish Bank, nationalised Northern Rock and is taking a stake in a number of other banks. The US government has closed 22 banks,[1] including Lehman Brothers, Washington Mutual and Indymac. It has rescued Freddie Mac, Fannie Mae, Bear Stearns and created a bailout fund of $700 billion to purchase stakes in troubled banks (Los Angeles Times, 4 October, 2008). Altogether the US government has committed nearly $8.5 trillion, around 60% of its gross domestic product, to arrest the collapse of its financial system (San Francisco Chronicle,[2] 26 November, 2008). The European Central Bank has provided around €467 billion to support banks. Germany has set aside over US$400 billion to bailout ailing banks (Wall Street Journal, 11 October, 2008). So far, Ireland, Iceland, Hungary and Turkey have sought financial assistance from the International Monetary Fund (IMF) to manage the crisis (The Guardian, 21 October, 2008, 29 October, 2008, 20 November, 2008).

Regulators and investors have traditionally relied upon corporate financial statements to make sense of bank liabilities, risks and economic exposure, but this has been highly problematic (Stiglitz, 2003). An early estimate suggested that despite a raft of accounting standards, banks had around US$5000 billion of assets and liabilities off balance sheet (Financial Times, 3 June, 2008) though this figure is being constantly revised. Citigroup alone has some US$1.23 trillion of assets in entities which are not shown on its balance sheet (Wall Street Journal,[3] 24 November, 2008). Some banks have shown assets, especially subprime mortgages, at highly inflated values and derivatives have long been a "powerful tool for inflating company profits by hiding losses and hence the risks of company operations" (Hildyard, 2008, p. 30). The chief executive of a leading financial advisory business argued that a "big part of the problem is that accounting rules have allowed banks to inflate the value of their assets. Accounting has become a new exercise in creative fiction, with the result that banks are carrying a lot of "sludge" assets clogging up the balance sheet" (Reuters,[4] 30 October, 2008).

Attention has focused on auditors because of the belief that "a green light from an auditor means that a company's accounting practices have passed muster" (New York Times, 13 April, 2008).[5] Table 1 shows that distressed financial enterprises, whether in the UK, USA, Germany, Iceland, The Netherlands, France or Switzerland, received unqualified audit opinions on their financial statements published immediately prior to the public declaration of financial difficulties. These opinions were provided by one of the Big Four accounting firms – PricewaterhouseCoopers (PwC), Deloitte & Touche (D&T), Ernst & Young (E&Y), and KPMG.

Admittedly, the list in Table 1 is incomplete, but it is useful for highlighting a number of issues. Adverse "key financial ratios" are considered to be an indicator of going concern problems (Auditing Practices Board, 2004a), and major institutions acquired leverage ratios in the range of 11:1–83:1 (Gros & Micossi, 2008). Excessive leverage has the potential to increase liquidity risk and jeopardise bank survival. For example, a report by the US Securities and Exchange Commission (SEC) noted that Bear Stearns "was highly leveraged, with a gross leverage ratio of approximately 33 to 1 prior to its collapse" (US Securities Exchange Commission, 2008, p. 19). One expert informed the US House of Representatives Committee on Oversight and Government Reform that Lehman Brothers, the fourth largest investment bank, "had a leverage of more than 30 to 1. With this leverage, a mere 3.3% drop in the value of assets wipes out the entire value of equity and makes the company insolvent".[6]

The UK auditing standards, closely aligned with international auditing standards, state that the "auditor's procedures necessarily involve a consideration of the entity's ability to continue in operational existence for the foreseeable future. In turn that necessitates consideration of both the current and the possible future circumstances of the business and the environment in which it operates" (Auditing Practices Board, 2004a, p. 8). Auditing standards also require auditors to "perform audit procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified" (Auditing Practices Board, 2004b, p. 3). How the auditors constructed audits to satisfy themselves that banks were a going concern are open to conjecture, but the financial difficulties of many became publicly evident soon after receiving unqualified audit reports.

For example, Lehman Brothers received an unqualified audit opinion on its annual accounts on 28 January 2008, followed by a clean bill of health on its quarterly accounts on 10 July 2008. However, by early August it was experiencing severe financial problems and filed for bankruptcy on 14 September 2008. Bear Stearns, America's fifth largest investment bank, received an unqualified audit opinion on 28 January 2008. However, by 10 March its financial problems hit the headlines and on 14 March, with state support, it was sold to JP Morgan Chase (US Securities

[1] As per information on the Federal Deposit Insurance Corporation (FDIC); http://www.fdic.gov/index.html-accessed on 25 November 2008.

[2] http://www.sfgate.com/cgi-bin/article.cgi?f=/c/a/2008/11/26/MNVN14C8QR.DTL; accessed on 26 November 2008.

[3] http://online.wsj.com/article/SB122747680752551447.html; accessed on 24 November 2008.

[4] http://www.reuters.com/article/GCA-CreditCrisis/idUSTRE49T77O20081030; accessed on 30 October 2008.

[5] http://www.nytimes.com/2008/04/13/business/13audit.html?_r=1&oref=slogin.

[6] http://oversight.house.gov/documents/20081006103223.pdf; accessed on 14 November 2008.