

## **Trust Me: I'm An Auditor!**

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*The objective of this paper is to consider the GFC from the perspective of the role of the auditing profession. While it is still too early to determine whether there will be many legal actions resulting from audit failures during the GFC, it is nevertheless timely to consider whether audit failures in the past are a predictor of the criticism, and possibly legal action, auditors may face as a result of the current crisis. This paper then considers the challenges facing auditors, the audit expectation gap, and the potential professional fallout for auditors from the GFC. It then concludes that the initiatives taken by the auditing profession after the corporate collapses and demise of Arthur Andersen a few years ago, have provided the profession with the strength it needed to cope with the excesses leading up to the GFC and that arguably time will tell that auditors can be trusted.*

### **1. Introduction**

Much has been written about the global financial crisis (GFC), with the press flooded with many questions such as did boards fail in their fiduciary duty to their shareholders; was creative accounting or fraud involved; did directors understand their company's business models and the associated risks; did the regulators fail; were the credit agencies at fault; did incentive-based cultures at financial institutions encourage greed and excessive risk-taking; were the problems generated by the rise of increasingly complex financial instruments; was there widespread ethical failure? (Tricker, 2009; Oakes, 2009; Saatchi, 2009). In contrast to earlier corporate crises, such as the collapse of Enron, WorldCom and Barings, it has been observed by Woods et al. (2009) that the role of auditors during the GFC appears to have received relatively limited media coverage, and in fact it has been the banking institutions themselves and the regulators who appear to be getting most of the blame. Nevertheless, a crucial question remains that has only recently been getting exposure: where were the auditors, the guardians and gatekeepers, the professionals we should be able to trust?

The objective of this paper is to consider the GFC from the perspective of the role of the auditing profession. While it is still too early to determine whether there will be many legal actions resulting from audit failures during the GFC, it is nevertheless timely to consider at the start whether audit failures in the past are a predictor of the criticism, and possibly legal action, auditors may face as a result of the current crisis. This paper then considers the challenges facing

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auditors, the audit expectation gap, the potential professional fallout for auditors from the GFC, and then concludes on the question of whether auditors can be trusted.

### 2. A History Lesson

If one was to look for the seminal event that changed the world of auditing, it would be the implosion of the then highly respected global accounting firm, Arthur Andersen, in 2002. A famous quote from a book written by Barbara Toffler about the downfall of Arthur Andersen (Toffler, 2003) crystallises the issue. Toffler, who had worked at Arthur Andersen and seen its ethical culture decay in the pursuit of higher profits, has noted a comment from Steve Samek, Country Managing Partner, Arthur Andersen United States (US), on the firm's Independence and Ethical Standards CD ROM, which was issued to staff in 1999. In an introduction to the CD, Samek observed that the day Arthur Andersen lost the public trust would be the day they would go out of business (Toffler, 2003).

Arthur Andersen, the prestigious global accounting firm established in 1913, with 85,000 employees worldwide went out of business in 2002. It was the first international accounting firm convicted on criminal charges because of its involvement in Enron, a conviction which was ironically overturned on appeal in 2005 but by then it was too late. Although Arthur Andersen was certainly not the largest of the then Big 5 Firms in terms of its auditing practice, it had experienced a disproportionate number of audit failures. These included a series of major audit failures at Waste Management, Sunbeam, Arizona Baptist Foundation, Global Crossing, WorldCom and Enron in the US, and Bond Corporation and HIH Insurance in Australia. Furthermore, these failures were not technical failures. For example, the creative accounting accepted by Arthur Andersen at WorldCom is what students would study in Accounting 101; at Enron, with its special purpose entities, it was Accounting 102. Arguably, the failure on the Arthur Andersen audits was not technical, but rather ethical failure.

As Leung and Cooper (2003) noted at the time, the opportunistic behaviour of managers and directors and the lack of transparency in large corporations, was compounded by the failure of the corporate watchdogs, such as auditors and regulators, to protect the public interest. The resultant subsequent tightening of the international auditing standards, and developments such as a new code of professional ethics for accountants, the passing of the Sarbanes Oxley Act in the US in 2002 and the CLERP 9 Act in Australia in 2004 are all now history, but have things changed? As the GFC plays out to its conclusion, a crucial question remains that has not yet had much exposure: where were the auditors? As observed by Tricker (2009), "... unqualified audit reports up to the collapse (GFC) had concluded that the directors' reports and accounts reasonably reflected reality. Yet, as is now known, the strategic model underlying the securitisation of mortgage debt and the expectation that financial markets would always be liquid was highly suspect,

and could expose businesses to massive risk, even the possibility of trading when insolvent and ultimately failing”.

### 3. The Changing Challenges Facing Auditors

An underlying feature of the GFC is that it developed during a period of rapid financialisation of Western economies, particularly in the US. As observed by Sikka (2009), this financialisation process created an abundance of credit and encouraged excessive risk-taking through complex financial instruments (such as derivatives, credit default swaps), and corporate structures and ineffective regulatory mechanisms must also share some blame. The fall out in the banking sector from this period of excess has been dramatic. The UK government nationalised Northern Rock and forced takeovers of banks in trouble, such as the Royal Bank of Scotland. The US government closed dozens of banks including well known institutions such as Lehman Brothers and Washington Mutual, and provided billions of dollars to rescue major financial institutions such as Freddie Mac, Fannie Mae and Bear Stearn. In Australia, the relatively strong banking sector received government guarantees.

The GFC has raised a key question relating to the basic auditing model and total auditor income. As Sikka (2009) observes, the auditing firms are capitalist enterprises and are dependent upon companies and their directors for income. “The fee dependency impairs claims of independence and has the capacity to silence auditors. It poses fundamental questions about the private sector model of auditing, which expects one set of capitalist entrepreneurs (auditors) to regulate another set of capitalist entrepreneurs (company directors)” (Sikka, 2009:p5). Tricker (2009) supports this view and observes that by the beginning of the 21st century, the five major accounting firms had become “.....vast, international and concentrated....they were major businesses, offering products and solutions...that auditing has ceased to be a profession: it has become a business”.

There is also the question of whether auditors now have the expertise to audit complex financial institutions. The earlier times of auditing in an industrial era represented by easily measurable tangible physical assets such as inventory and manufacturing plant has been eclipsed by complex financial instruments (for example, derivatives), whose value depends on uncertain future events and can be anything from zero to hundreds of millions of dollars. As noted by Sikka (2009), derivatives were central to the collapse of financial and non-financial businesses such as Barings, Enron and Parmalat. Also in the United Kingdom (UK), where the Royal Bank of Scotland as mentioned above has effectively been nationalised by the government, investors are beginning to question whether the auditors, Deloitte, should have spotted problems some time ago. Similar questions are being asked of KPMG, which audited HBOS and PricewaterhouseCoopers which audited Lloyds TSB – the other two big banks now getting state support (Dev & Rushe, 2009).

### 4. The Audit Expectation Gap

The audit expectation gap is arguably one of the major issues that have been confronting the auditing profession for a number of years. As observed by Leung *et al* (2009:p102), "...financial statement users such as investors, expect auditors to provide assurance concerning material fraud, irregularities and the viability of the business and its management. When entities fail through fraud or mismanagement, there is a tendency to blame the auditor for not having given adequate warning of the problems." Attempts to reduce the expectation gap through changes to the wording of the auditor's report, including the suggestion of a 'plain English' version, appear to remain unfilled (Leung et al., 2009).

There is no doubt that auditors remain nervous about the expectation gap and its interpretation by others outside the profession. Spence (2009) reported in the UK on a meeting of the Big 4 accounting firms with the Government, to plead for protection as they prepared for a surge in litigation from investors trying to recover their losses from big company failures. There were fears that a blockbuster lawsuit, if successful, could put one or more of them out of business and the Big 4 argued that this could trigger the collapse of the audit market and cause chaos for business. The ghost of Arthur Andersen still hangs heavy over the auditing profession. As Shields (2009) points out, ".....commentators are still bound to ask some big questions. Should auditors have predicted the liquidity and 'going concern' issues which resulted in the recent Government bail-outs? Should auditors have foreseen the 'big freeze' in the wholesale funding markets? " But then again as Shields (2009) further argues, ".....it would have been remarkable if they had done: most bank directors didn't see it coming and the same goes for rating agencies, regulators, economists, central banks and governments".

### 5. The Potential Professional Fall-out from the Current Financial Crisis – Are Auditors in Trouble?

Regardless of the expectation gap, a number of questions need to be asked. Is it possible we may have another implosion of an international accounting firm? Are we going to see an even more draconian Sarbanes Oxley version 2? Are auditors going to be pursued as scapegoats? So far, it appears that criticism and blame has focused primarily on individual banking institutions and the strength of their management and business models, remuneration structures and incentive based cultures (Oakes, 2009; Saatchi, 2009; Toynbee, 2009). The financial regulators and credit rating agencies have also found themselves subject to serious questioning, but auditors have largely escaped critical comment and the apportionment of blame. Indeed, the profession has been able to respond to criticism in some jurisdictions, by relying on official assurances by independent oversight bodies as to the general quality of audit work (Humphrey et al., 2009).

However, concerns remain and there are some ominous signs. In a recent article, Hughes (2009) refers to pictures being beamed around the world of

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the two PricewaterhouseCoopers partners arrested as part of the police investigations into the alleged massive fraud at Satyam in India. In the same week in London, “.....auditors were grilled by members of parliament about their role in the banking crisis, while in Miami, lawyers are gearing up for a landmark case against BDO, the fifth-biggest accounting firm.....just the latest in a sequence of events which have begged the age-old question of ‘where were the auditors?’” An earlier example is that in 2006, three auditors from the Japanese firm of ChuoAoyama PricewaterhouseCoopers were given a suspended prison sentence for their role in an accounting fraud at Kanebo Limited, a major cosmetics and textiles company (Sikka et al., 2009).

### 6. So, can auditors be trusted?

There is no doubt that since the seminal event of the implosion of Arthur Andersen in 2002, much has been done by the auditing profession and international standard setters to improve the quality of audits. There has also been a substantial upgrading of regulatory regimes, particularly in the US, UK and Australia. However, on a less positive note, the audit expectation gap, as discussed above, continues to exist. As Houghton et al. (2009:pxv) observe, “.....it is not possible that this gap can be ‘closed’. This is so for a number of reasons, including the perceived complexity of financial reports, which is a function of accounting standards and for which auditors cannot be held responsible. The wide disparity between retail and more sophisticated investors in terms of their understanding of financial and related reports is another reason for our view that the audit expectations gap is not closable”.

It is important to appreciate that an auditor gives an opinion on a set of financial statements at balance date and that many of the events that led to the collapse of companies such as Lehman Brothers and the Royal Bank of Scotland, happened very quickly between reporting periods. As pointed out by Woods et al. (2009:p118), it needs to be appreciated that “..... a key problem for auditors is the verification of the valuation of illiquid assets, bearing in mind the consequential impact that such valuations can have on the reported profits (or losses) of major banking institutions.....in volatile markets, significant adjustments to opinions on valuation may be required within a very short time frame, and for companies highly exposed to collateralised debt markets, valuing these elements of their balance sheets is not straightforward”.

The media in the last year or so has reported a number of valuation disputes between auditors and their clients. Smith (2008) has reported on the case of Bradford and Bingley, (a large bank in the UK that became a victim of the GFC) and its write-down of its synthetic collateralized debt obligations (CDOs) in closing its accounts for 2007. The auditor, KPMG, found itself in “tough talks” with management over the valuation of financial instruments – the critical nature of which was reinforced by subsequent events which saw the “nationalisation” by the UK government of the mortgage arm of Bradford and Bingley in September 2008. Goldstein and Henry (2007), provide another example of where auditors challenged the approach to accounting for assets within financial institutions, in relation to the valuations of certain assets held

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by two hedge funds managed by failed investment bank, Bear Stearns. Confidential documents the authors uncovered revealed that Deloitte and Touche, the funds' auditor, warned that the majority of the funds' net assets had been estimated by its own managers "in the absence of readily ascertainable market values". The above are examples of where auditors have found themselves in a difficult position in maintaining their independence and meeting their statutory obligations during the GFC.

At the time of writing, there have been relatively few negative observations about auditors and their role in the GFC. Houghton et al. (2009) have noted that while criticisms of bankers, regulators, directors and senior executives, advisory firms, hedge funds and other financial service organisations (among others) mount, little concern has been expressed about the role of audit. Houghton et al. (2009) have also observed that in some ways, the GFC can be seen as a stress test of audit, where the stress has not resulted in structural failure.

There is no doubt that the auditing profession has learned from the seminal event discussed earlier, namely the implosion in 2002 of Arthur Andersen. In Australia, the Financial Reporting Council is now a major force for the monitoring of the accounting and auditing profession, with control of both the Australian Accounting Standards Board and the Auditing and Assurance Standards Board, both of which were formerly controlled by the profession. The profession has also tried hard to salvage its credibility by actions such as adopting the International Federation of Accountants' *Code of Ethics for Professional Accountants* and also introducing into the code some more stringent ethical requirements. The Accounting and Auditing Standards have been made much more prescriptive and now have the force of law. The ethical standards contained in the professional bodies' code of ethics referred to above are referenced in the legally enforceable Australian Auditing Standards and in this context also now have the force of law. But can you really legislate trust and ethics? Will the GFC result in even more stringent regulation of the accounting profession?

At present, the profession has come through relatively unscathed by the GFC, but it is probably too early to determine what extra legislation or regulatory changes may evolve as a result of the GFC and how such developments will impact on the auditing profession. In fact it could be argued that the initiatives taken by the auditing profession after the corporate collapses and demise of Arthur Andersen a few years ago, provided the profession with the strength it needed to cope with the excesses leading up to the GFC. Regardless, what is needed going forward is uncompromising independence and ethical behaviour by auditors and reinforcement of the public trust, and the directions to date are arguably positive. So, in the eyes of the regulators, government and the investing public, can auditors be trusted? Time will tell.....trust me: I'm an auditor.....

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