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# The Watchdog that Didn't Bark ... Again

Presentation of the Working Group on Lessons  
Learned from the Financial Crisis  
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# The Sarbanes-Oxley Act

Roughly a decade ago, a series of massive corporate accounting scandals at some of the nation's most respected public companies rocked the markets, costing investors trillions of dollars in lost market value and leading to passage in 2002 of sweeping legislation to restore integrity to public company financial reporting practices and reliability to public company audits.

Central to the legislation were provisions to:

- Enhance auditor independence with an eye toward making auditors more willing to stand up to clients and insist on accurate financial reporting
- Create an independent audit oversight board responsible for raising audit standards and holding auditors accountable for meeting those standards

The common goal of these provisions was to restore auditors' credibility as public watchdogs dedicated to ensuring the accurate financial reporting on which the integrity and stability of the capital markets depend.

# The Financial Crisis

The recent financial crisis presented auditors, and by extension the Sarbanes-Oxley Act audit reforms, with their first big test since these reforms were put into place. By any objective measure, they failed that test.

- Dozens of the world's leading financial institutions failed, were sold in fire sales, or were prevented from failing only through a massive government intervention – all without a hint of advance warning on their financial statements that anything might be amiss.
- Investors suffered devastating losses. Millions of Americans lost their homes or their jobs, and \$11 trillion in household wealth has vanished, according to the Financial Crisis Inquiry Commission.
- As a result, serious questions have been raised both about the quality of these financial institutions' financial reporting practices and about the quality of audits that permitted those reporting practices to go unchecked.

# A Sampling of Failed Financial Institutions

All of which received unqualified audit opinions within months of the failure

Company	Event	Event Date	Investor Losses (\$m)*	Audit Firm
Lehman Bros.	Bankruptcy	9/15/2008	31,437.10	E&Y
AIG	TARP	9/16/2008	156,499.60	PwC
Citigroup	TARP	10/28/2008	212,065.20	KPMG
Fannie Mae	Gov't takeover	9/6/2008	64,100.00	Deloitte
Freddie Mac	Gov't takeover	9/2/2008	41,200.00	PwC
Wash Mutual	Bankruptcy	9/26/2008	30,558.50	Deloitte
New Century	Bankruptcy	4/2/2007	2,576.40	KPMG
Bear Sterns	Purchased	3/17/2008	20,896.80	Deloitte
Countrywide	Purchased	1/11/2008	22,776.00	KPMG

\* Calculated based on decline in market capitalization from one year prior to the event and the event date. Fannie Mae and Freddie Mac data is from 10/9/07 and 9/12/08.

# The Role of Auditors

While auditors did not cause the financial crisis, it is difficult to look at the list of failed institutions that received an unqualified audit just months before they failed and conclude that auditors didn't play a role. For example:

- Did auditors' failure to adequately test or challenge company valuation methods allow companies to hide their deteriorating financial condition from investors and regulators alike?
- Did auditors inappropriately allow companies to hide risks off-balance-sheet when the company remained exposed to the risks?
- Did auditors inappropriately agree to, or even help design, transactions whose sole purpose was to hide from investors the degree of leverage or other risks the company had taken on?

If the answer to these questions is yes, these practices not only deprived investors of important information, they encouraged companies to take on risks they might have avoided if those risks were required to be fully disclosed, and contributed to the freezing of the credit markets once the crisis struck. Moreover, if true, they revealed what the UK's FSA has labeled "a worrying lack of professional skepticism."

# The Expectations Gap

In the wake of the crisis, investors and independent commentators have been highly critical of the auditors for these failures and of regulators for failing to hold them accountable.

“The public accounting firms and their hundreds of thousands of auditors should be an investor’s first line of independent defense. But these firms turned a blind eye to the excesses, mismanagement, and fraud of executives managing their client firms. The public accounting firms issued clean financial opinions for all of the firms that eventually, most less than a year later, failed, were taken over, or nationalized. And the regulators slept.”

-- Francine McKenna, blogger

“Here we had the greatest banking industry meltdown since the Great Depression. Hundreds of lenders failed. And yet the number of banks correcting accounting errors declined while the collapse was unfolding. There were no restatements by the likes of IndyMac, Washington Mutual or Lehman Brothers, for example. The obvious conclusion is the government has been giving lots of banks a free pass, as have their auditors.”

-- Jonathan Weil, columnist

# The Expectations Gap

In a recent blog, Tom Slee went so far as to ask, “Are Auditors Becoming Irrelevant?”

“Now that we have had time to analyze the financial crisis and the post-mortems are over, one big question remains. Where were the auditors? These highly-paid watchdogs were supposed to be our first line of defense. Fat chance! They continued to reassure shareholders and investors even while we were going over the cliff. Bear Sterns, Carlyle Capital, Thornburg Mortgage, and Lehman Brothers all hit the buffers shortly after receiving clean bills of health...”

“So why have we not heard a lot more about the auditors’ role in the great crash? ... I think that one of the main reasons public auditors have been marginalized is because they are no longer regarded as independent professionals. Certainly most institutional investors see them as an extension of management, fiercely loyal to their employers, the boards of directors ... Moreover, auditors have lost a lot of credibility by hedging their opinions and making sure that management is solely responsible for the numbers ... Perhaps most important, auditors are no longer equipped to pass judgment on a great many aspects of financial statements...”

“Where does this leave small investors? Well, I think we have lost another safeguard.”

# The Expectations Gap

But auditors have defended their performance in the crisis.

“We believe that auditors generally carried out their role effectively during the crisis and appropriately reached audit opinions within the context of the applicable accounting and auditing frameworks.”

-- Center for Audit Quality

“When it comes to professional skepticism, the regulators’ perspective appears to be different to the auditing profession’s. We view our role as one of ensuring management has appropriate robust evidence to support its assumptions. It is not for us to present an alternative view and try to get management to accept it as better than theirs.”

-- Richard Sexton

PwC’s head of audit in the UK

"Let us be clear. The committee concluded last year that there was little evidence to suggest that auditors failed in their duties in the run up to the financial crisis."

-- Michael Izza

ICAEW chief executive

# Auditors Escape Repercussions

At least in the United States, auditors have largely been let off the hook in the post-mortems that examined the causes of and appropriate policy responses to the 2008 financial crisis. To the degree that Congress weighed in on financial reporting issues during the Dodd-Frank Act debate, it used its authority:

- To undermine the independence of the accounting standard-setting process by intimidating FASB into weakening its mark-to-market accounting standard
- To weaken protections against accounting fraud and errors at small public companies by repealing the SOX 404(b) internal controls requirements for companies with less than \$75 million in market capitalization and requiring a study of whether further roll-backs are needed

Moreover, more than two years after the crisis broke, we've seen no major enforcement actions by the SEC or PCAOB holding auditors accountable.

# The FCIC Report

The Financial Crisis Inquiry Commission report discusses the lack of transparency on financial institutions' balance sheets. The report notes, for example, that:

- Even as financial institutions were taking on disturbing amounts of leverage, “leverage or capital inadequacy at many institutions was even greater than reported when one takes into account ‘window dressing,’ off-balance-sheet exposures ..., and derivatives positions ...”
- “Several investment banks artificially lowered leverage ratios by selling assets right before the reporting period and subsequently buying them back.”

But the report focuses more on problems with these institutions' reporting practices than on the role of auditors in acquiescing to those reporting practices. On the other hand, the FCIC report and documents on the FCIC website do provide greater insight into two cases that raise disturbing questions about auditors' performance during the crisis – PwC's audits of AIG and KPMG's audits of Citigroup.

# The FCIC Report

## **AIG, Goldman Sachs and Pricewaterhouse Coopers**

The FCIC report describes at some length the collateral dispute that arose between AIG and its counterparties, bringing the company to the brink of collapse and resulting in a massive government bailout. Among the more telling items in that account:

- When the issue first arose in 2007, AIG Financial Products did not have its own model or otherwise try to value the CDO portfolio that it guaranteed through credit default swaps, nor did it hedge its exposure. This despite the fact that the company's \$79 billion exposure equaled more than 80% of the parent company's \$95.8 billion in total reported capital.
- One wonders how PwC, which audited both AIG and Goldman Sachs, could have signed off on AIG's financial statements or attested to the adequacy of AIG's controls over financial reporting when it had no independent basis for valuing an exposure of this magnitude. According to the FCIC report, PwC was apparently unaware of the CDS collateral requirements and thus concluded along with AIG that there were "no substantive economic risks in the portfolio."

# The FCIC Report

- In November of 2007, with collateral demands piling up, AIG decided to use a “negative basis adjustment” to reduce its unrealized loss estimate from \$5.1 billion to about \$1.5 billion. It did so with the knowledge of PwC, which apparently raised no objections at the time.
- Meanwhile, in meetings during the same period with company management, the auditor laid out “significant concerns” about risk management practices, in particular practices related to valuation of the CDS portfolio as well as procedures for posting collateral. The auditor reportedly told AIG that these and other issues raised control concerns around risk management that “could be a material weakness.”
- It wasn’t until February 6, 2008 that PwC informed the chairman of AIG’s board that the \$1.5 billion estimate disclosed on the December 5 investor call had been “improper and unsupported.” PwC concluded that this constituted a material weakness and that the numbers AIG had publicly reported would have to be corrected. As the FCIC report states, “Why the auditors waited so long to make this pronouncement is unclear, particularly given that PwC had known about the adjustment in November.”

# The FCIC Report

## **Citigroup, OCC and KPMG**

The FCIC report does not mention issues that arose around KPMG's audit of Citigroup, but the Committee's website includes a document that raises serious questions.

- In February of 2008, the Office of the Comptroller of the Currency sent a letter to Citigroup's CEO summarizing the findings of the agency's special supervisory review. The letter was highly critical of Citigroup's internal controls and its valuation methods for subprime mortgage bonds.
- The OCC copied Citigroup's lead auditor on the letter, ensuring that KPMG was aware of the problems even if their own review of the company's internal controls had not uncovered the issues identified by OCC.
- Nonetheless, just eight days later, Citigroup filed its annual report stating that "management believes that, as of Dec. 31, 2007, the company's internal controls over financial reporting is effective." The annual report included a letter from KPMG attesting to the effectiveness of Citigroup's controls.

# The PCAOB Report

The PCAOB issued a report in September 2010 based on the observations of PCAOB inspectors during inspections conducted during the critical years of the financial crisis. Although not really designed as a crisis post-mortem, the PCAOB report includes some valuable insights into practices that may have contributed to audit failures. To highlight just a couple:

- In the crucial area of fair value measurement, inspectors observed numerous short-comings, including failure to adequately evaluate whether fair value measurements were determined using appropriate valuation methods, the reasonableness of management's significant assumptions, and available evidence that was inconsistent with issuers' fair value estimates.
- In the equally important area of off-balance sheet structures, inspectors found that auditors failed to conduct adequate tests to determine whether the transactions were appropriately accounted for as off-balance-sheet arrangements or to test for the occurrence of events that would affect the accounting for these arrangements.

# The PCAOB Report

While the PCAOB report offers valuable insights into audit practices at the height of the financial crisis, several factors limit its usefulness as a guide to policy failures.

- Its focus is on the effect of the financial crisis on audits rather than on how auditor failures may have contributed to the financial crisis.
- It presents its findings in the most generalized terms, without providing any sense of how pervasive the identified problems were and without providing a narrative of how these audit failures contributed to the financial crisis.
- It identifies areas where auditors failed to perform up to standards, but it does not attempt to analyze why these failures occurred or what needs to be done to prevent a recurrence.

In short, the PCAOB report provides a starting point, but a starting point only, for the careful examination that is needed of how auditors contributed to the financial crisis and why they failed to fulfill their watchdog functions.

# The Way Forward

The financial crisis of 2008 raises significant questions about why the Sarbanes-Oxley reforms failed to bring about the promised improvements to the independence and quality of public company audits. In Europe and the United Kingdom, these questions are receiving significant attention from regulators and policymakers. But, so far at least, the United States has lagged behind in that evaluation.

The Working Group on Lessons Learned from the Financial Crisis strongly recommends that the PCAOB launch an in-depth study into the role auditors played in the financial crisis. The goal of that study should be to identify both the causes of and remedies for those pervasive audit failures.

In addition, we recommend that the PCAOB make this in-depth analysis of audit failures an on-going function of the Board, in order to ensure that changes in policy and oversight practices are adopted in a timely fashion to address correctable weaknesses in the audit process.