National Chengchi University
Department of Accounting
Ph.D. Qualifying Examination – Auditing
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PART I

The following article was first published on September 18, 2008 at the guardian.co.uk, and then discussed widely by the auditing profession in the Europe as well as in the US:

Accounting for the auditors

As huge corporations tumble, what of the auditing firms paid millions to provide them with clean bills of health?

By Prem Sikka, Thursday, September 18 2008 16:30 BST

In the current financial turmoil, companies are falling like ninepins. Lehman Brothers is in administration. Northern Rock, Fannie Mae and Freddie Mac have been bailed out and the list of vulnerable banks is growing. Bear Stearns and Merrill Lynch have been sold at knockdown prices and HBOS has merged with Lloyds TSB. Governments are pouring vast amounts of money to bail out financial institutions. Amidst the mayhem, we need to ask questions about the role of auditors, who have been paid millions of pounds to give opinions on company financial statements. Yet companies are sinking within weeks of getting a clean bill of health.

Ever since the 1998 collapse of Long Term Capital Management (LTCM) and its rescue by the US Federal Reserve, it has been acknowledged that derivatives are very difficult to value. In this case Nobel prize winners in economics could not work out the value of such financial instruments. Derivatives are central to the demise of Lehman. Its annual accounts mention derivatives contracts with a face value of $738bn and fair value of $36.8bn.

Lehman Brothers, incorporated in the tax haven of Delaware, was audited by the New York office of Ernst & Young. On January 28 2008, the firm gave a clean bill of health to Lehman accounts for the year to November 30 2007. The auditor's report (page 75 of the accounts) says, "Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances". Lehman Brothers filed quarterly accounts with the SEC for the period of May 31 2008 and on July 10 2008 and these too received a clean bill of health. Despite the deepening financial crisis, auditors did not express any reservations about the value of the derivatives or any scenarios under which company may be unable to honor its obligations. Just two months later, Lehman collapsed.

During 2007, Ernst & Young collected fees of $31,307,000 from Lehman Brothers, compared to $29,451,000 for 2006. The fees for 2005 and 2004 were $25,324,000 and $24,748,000 respectively. Over the last four years, Ernst & Young collected over $110m in fees, of which nearly $14m is for advice on tax and other consultancy services.

The scale of fees raises questions about auditor independence. By providing other services auditors begin to perform quasi management functions and cannot objectively evaluate the outcome of the transactions they themselves have helped to create. The fee of $110M for the New York office of Ernst & Young is likely to be significant in influencing the financial rewards of local partners and managers. The fee dependency exerts pressure on auditors to acquiesce with management. Such concerns were raised during the demise of WorldCom, Maxwell, Enron and more recently in the insolvency examiner's report on the collapse of New Century.

Audit opinions are akin to financial mirages. In recent weeks, within a short period of receiving clean bills of health Bear Stearns, Carlyle Capital Corporation and Thornburg Mortgage hit the financial buffers, closely followed by Lehman Brothers.

Time and time again it has been shown that the basic audit model is faulty. Private sector auditors cannot be independent of the companies that they audit. This fundamental faultline has not been addressed by the post Enron reforms. In addition, the ex-post financial audits are too late and cannot alert financial regulators of problems. The financial regulators have a wider remit and are also concerned with the financial health of the whole system. These shortcomings were recognized after the 1929 stock market crash. The draft legislation that created the SEC in the 1930s contained a provision making the SEC the auditor for public companies, but under pressure from corporate interests, legislation was diluted.

It is time to go back to the future and ensure that audits of major companies, at least banks and financial institutions, are carried out directly by the regulators. These audits should be on a real-time basis. Audits by regulators have the advantage of independence and can address regulatory issues. Accounting firms and companies used to softer audits will no doubt fight tooth-and-nail to retain their privileges, but we can't continue to indulge accounting firms and pay billions to rescue banks.

Required:

(a) Identify as many auditing issues as possible from the above article. Cite prior studies that address these issues and briefly describe their major findings. **(45 points)**

(b) Should Ernst & Young be legally liable for the Lehman Brothers' bankruptcy? Why or why not? **(10 points)**

(c) Criticize on the author's comments that are invalid or inappropriate to you. **(10 points)**

(d) Although Slim Kebaili, the super-star fund manager of the Actio Croissance Plus fund, is positive about the US Federal's nationalisation of Fannie and Freddie alongside AIG, he is worried that the proposed $700 billion National Rescue Fund will prove too complex. In fact, Slim Kebaili argues that *auditors will be the main beneficiaries of the vehicle*.

    What are the possible reasons underlying Kebaili's argument? Do you agree or disagree with his argument? **(10 points)**