Editorial: I see no ships – all's well[1]

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Today, there is a popular mantra that we should 'move on' and avoid recriminations for past mistakes. Therefore, it might appear a little unseemly to suggest that auditors and regulators need a proper understanding of past audit failures for clues for handling the future. For hundreds of years, the autopsy has figured as an indispensable practice in medicine for trying to ascertain what killed the patient. And if murder is the cause of death, is it so farfetched to suggest that jail-time would be appropriate for anyone who murdered the world-economy?[2]

Such a suggestion is not without precedent. In ancient times in Africa, tax delinquents were executed – by the Royal Accountant – who was also the Minister of Finances (Sy and Tinker, 2006).

Consider the time-line below and ask whether the economic meltdown was death-by-suicide, death-by-accident or just murder.

> "In June 2003, the Securities and Exchange Commission (SEC) implemented Section 404 of the Sarbanes-Oxley Act of 2002 (the 'Act') by adopting rules requiring issuers [management] to include in their annual reports an assessment of the company's internal control over financial reporting as well as an auditor's report on that assessment. Soon after, as required by Sections 404(b) and 103 of the Act, the Board adopted Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements ('AS No. 2'), to apply to the newly required audits. The SEC approved AS No. 2 on June 17, 2004." PCAOB Release 2006–2007, 19 December 2006, p.2.

This PCAOB announcement delineates the responsibilities of management, to report on the efficacy of their system of internal controls and the auditor's responsibilities to report on management's report. Note the date – December 19, 2004 – just prior to the bubble-bursting of the sub-prime housing asset market.

Much like the lookouts on the Titanic, the PCAOB and the auditors were still crying: 'All's well':

> "Two annual financial reporting cycles have been completed since public company auditors began applying AS No. 2 to audits of accelerated filer. During this time, the PCAOB has closely monitored implementation of the standard and the progress auditors have made in complying with its requirements. The PCAOB's monitoring has included ... inspections of registered public accounting firm...roundtable discussions...receiving feedback from ... the Board's Forums on Auditing in the Small Business Environment and reviewing academic, government and other reports and studies (op. cit)."

Although, all was 'not well', the PCAOB still thought fit to give itself a pat on its back:

> "From all of these sources of information, two basic propositions have emerged. First, the audit of internal control over financial reporting has produced significant benefits. Issuers and auditors have described a focus on corporate governance that had not existed in the past and improvements in the quality and efficiency of important corporate processes and controls." PCAOB Release 2006–2007, 19 December 2006, p.2. Item 308 of Regulation S-K, 17 C.F.R. § 229.308 (for auditor liability).

'I see no ships.[3] All's well.'

It is no great secret as to what constitutes an adequate system of internal control. A bank, for instance, should have adequate precautions to ensure that monies (mortgages) are only given to clients who are capable of repayment. This is Auditing 101. In the 1970s,

the $4 billion collapse of Lincoln Savings and Loans was precipitated by a failure to conduct any credit checks for some 40 borrowers (mostly close associates of Charles Keating). This resulted in criminal prosecution (for file stuffing). In the $500 million Savings and Loans collapse, accountings firms paid out millions in damages. They subsequently successfully lobbied Congress for the Tort Reform Act that limited their future liabilities to a proportional basis. Plaintiffs were therefore precluded from recourse from all defendants to recoup their losses. Only one member of Congress voted against Tort Reform.

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These concerns about audit failures cannot be dismissed as 'Monday-morning quarterbacking' as there were plenty of straws in the wind regarding the subprime crisis. For instance, investors have recently filed a $1 billion law suit against KPMG, for failing to conduct a proper audit of New Century Financial, putatively the bellwether of subprime bank failures.

> "ALTHOUGH he had been with the mortgage lender New Century Financial for only two months, Tajvinder S. Bindra had spent a good part of late 2006 and early 2007 pelting the company's controller and a member of its auditing firm, KPMG, with questions about the company's accounting. Frustrated by their responses and staring down a deadline to close New Century's year-end books, Mr. Bindra, the company's chief financial officer, told both men that he needed written assurances from KPMG that New Century's bookkeeping was proper... But KPMG balked. A few weeks later, on Jan. 31, 2007, KPMG and New Century's own accountants stunned the company's board by revealing that the lender had incorrectly calculated its reserves for troubled home loans. That mistake was likely to cost New Century $300 million, wiping out all of its profits from the second half of 2006. Two months later, New Century, one of the largest subprime mortgage lenders in the country, would be bankrupt." (Bajaj and Creswell, New York Times, 13 April, 2008) (Vikas and Creswell, 2008; Wallstreetwatch, 2009).

In the latest suit against KPMG, the FT reports that liquidators claim that:

> "KPMG was responsible for New Century's collapse because it allowed the lender to understate the size of the bad load problem and even 'silenced' KPMG experts who raised red flags.... for fear of upsetting the client.... The complaint alleges that the audit acquiesced to client demands..." (Hughes, 2009).

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In the subprime meltdown, internal controls were often optional. In Florida for instance, some office-secretaries had five investment homes, worth millions of dollars that they flipped on a regular basis. Mortgage licenses were given out so freely, that over 10,000 convicted criminals entered the mortgage business (Packer, 2009). Florida's World Savings Bank (owned by Wachovia) offered 'Pick and Pay' loans, where customers were invited to design their own mortgages, choose their own interest rate, repayment period, all without a credit check (op. cit). No proper system of internal control would have permitted these practices.

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Academics performed admirably in perpetuating the subprime malaise. In North American universities, auditing is still the poor-relation in accounting course syllabi that are still geared to the publishing research-interests of faculty – financial accounting. Many students graduate audit-lite. Small wonder they are outwitted in the field by canny management. Notwithstanding this lamentable record, the PCAOB still saw fit to acknowledge its debt to academics for lending their imprimatur to their deliberations.

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Forgotten by the PCAOB and their academic friends is Watts and Zimmerman's warning in their 'Market for Excuses' award winning paper (Watts and Zimmerman, 1979). Watts and Zimmerman initially fired their 'hired excuses' salvo at Abe Briloff, in an attempt to shut-down his critical articles in Barron's. Briloff's criticisms were costing the firms and their clients millions of dollars in litigation proceedings. Briloff's articles were also galvanising Congress and the regulators into action and causing the clients' stock price to tank (Briloff, 1972, 1985; Foster, 1987; US Congress, 1976a, 1976b).

Watt's and Zimmerman declared that Briloff's articles should be dismissed because Briloff was merely a hired-gun, rented by a profit-making publication – Barrons. However, the 'Excuses' thesis rapidly fell into disfavour because of its inherent contradictions. The 'Excuses' criticism could also be applied, with greater force, to Watts and Zimmerman themselves. After all, endowed chairs at the Universities of Rochester, Chicago and their acolytes, run into millions of dollars. Those chair-holders were much better targets for the accusation of 'excuse-blowing' than Abe Briloff and his relatively impoverished inner city home a Baruch College.

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Unfortunately, memory is short-lived regarding the 'Market for Excuses' saga. As recently as May 2009, Stanford University's Professor Mary Barth was once again trumpeting to impressionable European doctoral students, the counsel of the virtuous 'independent academic'. 'Independent academic' was shouted-out several times during her presentation to this prestigious gathering of the 2009 Tempere European Accounting Association meeting. For Professor Barth, the 'independent advice' of academics was a 'gift that kept on giving' to the International Financial Accounting Standard Board (IFASB). However, Professor Barth's shibboleth of 'independent academics' were never qualified with a disclosure of possible conflicts of interest. No mention was made of the millions of dollars invested in the funded chairs of US accountings professors, nor of the millions more taken by US schools and accounting departments like Stanford University (Barth, 2009).

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Now when academic aren't up to the job, accounting firms have been all-too-ready to step into the breach. Over the years, they have done a stellar-job in systematically dismantling the regulatory system. The financial sector as a whole spent \$5.1 billion in lobbying Congress over the last decade, political campaign contributions of more than \$1.7 billion in federal elections from 1998–2008. A large chunk of this change came from the accounting firms, who spent \$81 million on campaign contributions and \$122 million on lobbying (Corp-focus, 2009).

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Tort Reform was the great coup for the accounting lobby. This legislation was promoted by Democratic Senators Dobb and Lieberman (Connecticut) who overturned the veto of their own Democratic President Clinton who was concerned that Tort Reform would weaken the accountability of audit firms. Dobb and Lieberman were simply representing the interests of the most powerful constituents of their state: large accounting firms, insurance firms and other financial institutions. To express their gratitude for the successful passage of Tort Reform, Dobb received thousands of dollars in contributions for his election campaign fund, after passage of the legislation. Dobb wasn't even due to run for reelection (op. cit).[4]

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Today's World Wide Depression has many causes, which is not to say that no-one is to blame. Indeed, several firewalls, if they had held, might have prevented the meltdown.

1 Accounting educators failed to instill in students a proper technical and moral competence such that, when they left school for work, they could effect proper systems of internal control.

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2 Accounting researchers continue to neglect the audit failures as a vital and urgent object of research.

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3 Auditors closed their eyes to banking management's failure to design and operate a proper system of internal control.

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4 The PCAOB and the SEC failed in their oversight duties regarding auditors and their clients concerning the status of the client's internal control systems.

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5 The Federal Reserve's low interest rates fueled bubble blowing by banks, leading to the Sub-Prime bubble.

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Code words like 'blame game' and 'moving forward' are rhetorical devices for evading responsibility and accountability. Unless responsibility for incompetence, compromise and/or misconduct is fully explored, a proper investigation as to causes cannot begin and justice – to the victims – remain incomplete. Accountability today is a debt owed to the future; if it remains unpaid, it will be collected from future generations – with interest.

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Notes

1 Please do not quote from this paper without the prior permission of the authors.

2 Hopefully, it won't be lost on an academic readership that there are 'real' consequences from an audit-failure induced economic depression. Fifty million people in developing countries will fall below the poverty line – including many children. For some, that will mean malnutrition and death. But no matter; let's 'move on' and not try to litigate the past.

3 Like all idioms, the quote from Admiral Lord Horatio Nelson speaks both more and less. Auditors and regulators – like Nelson – knew that they could really see the enemy fleet. Also, like Nelson, they chose not to admit the sighting. But that's where the parallel ends. Horatio Nelson had put the spyglass to his glass eye (he had been blinded in the earlier Battle of the Nile). The ruse allowed Nelson to disobey the High Admiralty' orders to avoid engagement with the numerically superior French fleet. Nelson went on to successfully defeat the French at Trafalgar, but lost his life to a French sniper in the engagement. In contrast, the auditors and regulators in the subprime debacle scarpered from the field of battle. Finally, the subtitle, 'All's well' was the mariner's traditional cry from a ship's birds-nest. 'All's well' meant that there were no enemy ships, nor bad weather, in sight.

4 Senator Dobb owes President Clinton an even great debt: it was Clinton who secured for Dobb the Chair of the powerful Democrat National Committee. This makes Dobb's betrayal even more poignant. More recently, Dobb's conflicts of interest also got him in hot water concerning his softly-softly treatment of his banking constituents in the Troubled Assets Relief Program (TARP). He was forced to publicly apologise.