

Unaccountable external auditors

BY GILBERT GEIS, PH.D., CFE

External auditing firms are supposed to provide detailed, accurate and unbiased information about the finances of their clients. However, the author contends that the failures of many external auditors helped contribute to the recent "Great Economic Meltdown." He says a radical overhaul of the U.S. system of external auditing of corporate financial affairs is necessary.

The Securities and Exchange Commission (SEC) has been pelted with criticism for its failure to monitor the investment banks and other irresponsible entities whose reckless behavior, shenanigans and financial crimes collectively triggered what became known as the "Great Economic Meltdown" in 2008 and beyond.

Presumably because of the lack of adequate funding, the SEC failed to stem the self-indulgent excesses of real estate brokers and financial institutions involved in the subprime lending racket and toward Wall Street investment firms that were avidly marketing toxic mortgage derivatives. The peddlers of these polluted and often largely incomprehensible papers, not coincidentally, were reaping extremely high profits.

There were, as well, other corporate and partnership culprits who participated in the affairs leading to the meltdown that have largely remained out of the limelight. One group of these organizations — the external auditing firms that are supposed to provide reliable information about the financial situation of their clients — constitutes the subject matter of this article.

The role of accountants in the economic recession has barely been considered. An exception was an article in the business section of The New York Times that deals with the loose rules promulgated and still defended by professional organizations such as the Financial Accounting Standards Board.

The article carries the telling headline "Accountants Misled Us Into Crisis." The story jumps to a headline inside that may prove prescient if effective remedial measures aren't put in place. It reads: "It Could Happen Again" (Norris 2009, B4, <http://tinyurl.com/8hld6e6>).

In the following pages, I provide evidence to support the argument that a radical overhaul in the U.S. system of external auditing of corporate financial affairs is necessary.

The Rakoff remedy

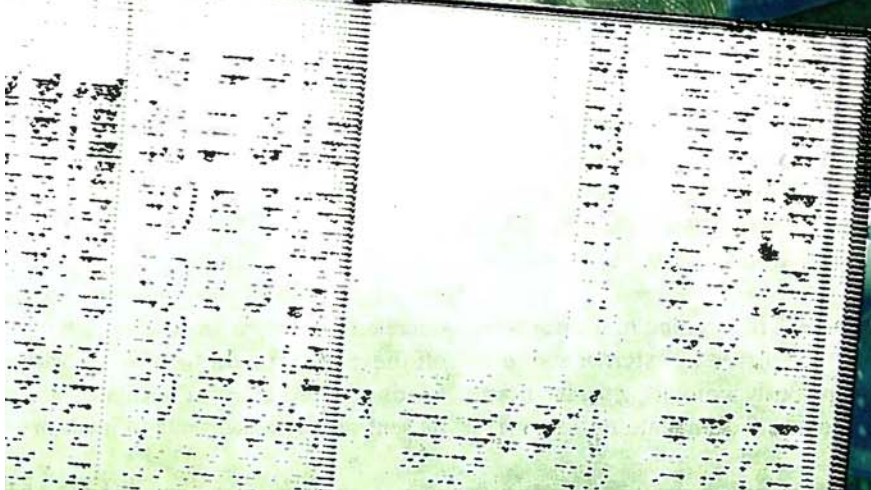
One of the developments in the meltdown cleanup involved the merger of Bank of America, nudged rather strenuously by the U.S. Department of the Treasury, with a near-bankrupt Merrill Lynch. Bank of America (itself the recipient of a government loan) failed to tell its shareholders, who had to approve the blending of the two companies, that Merrill Lynch would dole out huge — some would call them obscene — bonuses that would reduce its value to its purchaser. In the fourth quarter of 2008, Merrill Lynch suffered losses of

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Their roles in the 'Great Economic Meltdown' *Part 1 of 2*



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\$15 billion, yet it allocated \$3.6 billion of its funds for executive bonuses.

The SEC charged Bank of America in civil court for hiding these facts from its stockholders; the corporation agreed to settle the case by paying a \$33 million penalty. A federal district judge had to approve it for the deal to be clinched. Judge Jed Rakoff, reputed to be something of a curmudgeon, rebelled. He wanted to know, among other things, why the company was expropriating money from shareholders to pay the fine rather than getting the funds from the lawyers who had failed to mention the bonuses in the proxy statement. Or as Rakoff noted, why not penalize Bank of America executives who either knowingly or negligently let this happen? Rakoff refused to approve the settlement (*SEC v. Bank of America* 2009, <http://tinyurl.com/9brjjww>).

Five months later, however, Rakoff “reluctantly” agreed to a \$150 million settlement, thereby expropriating even more of the shareholders’ money than in the original plan. Conceding that the new agreement was “far from ideal,” he apparently relented because it seemed likely that the New York attorney general would press a criminal case against Bank of America and individuals involved in the merger arrangements. The charges haven’t been forthcoming.

A pair of investigative reporters maintained that then Secretary of the Treasury Timothy Geithner and then New York State Attorney General Andrew Cuomo had cut a deal not to charge the corporations or their executives criminally because it would roil an already unsettled marketplace (Morgenson and Story 2011b; <http://tinyurl.com/3nqz2la>).

The same two reporters subsequently noted that the Department of Justice had adopted guidelines favoring a “deferred prosecution” approach to white-collar criminals, whereby they would be put on warning to behave thereafter or to face a delayed prosecution (Morgenson and Story 2011a; <http://tinyurl.com/6e8bw4u>).

Particularly noteworthy was an item in the Bank of America settlement that

received no coverage in the media. The parties had agreed to submit proposed bonuses to a nonbinding vote by shareholders within the following three years, and during the same time period to appoint an independent “disclosure counsel” who would report solely to the audit committee of Bank of America’s board of directors on the adequacy of the bank’s

Dalmady pointed out that the SIB auditor was an island firm whose principal was a 72-year-old man who had been examining the company’s books for at least a decade, despite the fact that PwC and KPMG both had offices in Antigua.

public disclosures. Rakoff added a further element to the oversight proposal that was especially interesting:

In order to further strengthen these prophylactic measures, the Court suggested at the hearing on February 8, 2010 that the independent auditor and the disclosure counsel not just be chosen in consultation with the S.E.C. but rather be fully acceptable to the S.E.C. with the Court having the final say if the two sides could not agree on the selection. The parties, by letter dated February 16, 2010, have subsequently agreed to these suggestions, which will therefore need to be incorporated in a revised Proposed Consent judgment to be presented to the Court (SEC v. Bank of America 2010, 3).

Rakoff’s recognition of the key role that can be played by external auditors in scrupulously monitoring the financial affairs of their clients attests to a very

significant subplot in both the recent economic meltdown and earlier business scandals.

The Madoff maelstrom

It was a difficult task for the media, especially television, to get a firm grasp on the ingredients that constituted the Great Economic Meltdown. Arcane financial transactions, such as synthetic CDOs (collateralized debt obligation), do not make for rousing images. Also, no attention was paid to the matter that had moved Judge Rakoff to try to fashion a remedy. Despite flagrant mismanagement and irresponsible risk taking by insurance giants such as the American International Group (AIG) and by investment banks such as Goldman Sachs, Bear Stearns and Lehman Brothers, the question never arose as to why outside auditors hadn’t spotted the accounting chicanery that marked the perhaps illegal and certainly ill-advised corporate activities. Nor were there questions about why they hadn’t alerted government officials and the public to what was occurring.

Bernard Madoff attracted the most intense media and prosecutorial scrutiny in part because the Ponzi scheme he operated was so brazen and simple-minded, and many of its victims were so well known. Madoff himself was a person whose glamorous lifestyle could be depicted in terms vivid enough to satisfy viewers and readers (see, e.g., Arvedlund 2009; Kirtzman 2009; Kotz 2009; LeBor 2009; Markopolos 2010; Oppenheimer 2009; Ross 2009; Sander 2009; Strober and Strober 2009). The Madoff case was the only instance in the meltdown that addressed a basic question: Where were the external auditors while all this was going on?

Madoff allegedly cheated about 8,000 investors in his scheme of somewhere between \$15 billion and \$65 billion. The exact figure varies with the source. He operated over a span of 40 years, paying off those who sought to cash out with funds secured from new clients, and he sent regular statements to investors

detailing their holdings and their illusory high level of profits.

It apparently never occurred to Madoff's clients to exercise due diligence that would involve checking out the person or organization responsible for auditing his company's books. Had they done so, they would have learned that the Madoff enterprise was audited by Friehling & Horowitz, a firm that occupied a 13-foot x 18-foot storefront office in the village of New City, about 30 miles north of Manhattan. David G. Friehling, 49, the only professional accountant in the office, had been auditing Madoff's books since 1991. Jeremy Horowitz, Friehling's father-in-law and cofounder of the firm, had retired to Florida. He died of cancer on the day that Madoff received a 150-year prison sentence.

Friehling proved an easy target for the authorities. Prosecutors noted that he had signed off on a report to the SEC indicating that Madoff's firm had \$1.09 billion in assets and \$425 million in liabilities. The figures were phony. He pleaded guilty in November 2009 to single counts each of securities and investment advisor fraud, four counts of making false filings with the SEC and three counts of obstructing and impeding the administration of the federal tax laws — the last on the grounds that he prepared phony tax returns for Madoff and unidentified others.

Friehling was fined \$3.18 million, the sum representing his fees from Madoff and his investment in the company. He said that at no time had he been aware that Madoff was operating a Ponzi scheme. Friehling sought to support this claim by pointing out that he had lost about \$500,000 in personal investments in Bernard L. Madoff Investment Securities. He said that he took the documents that were presented to him from the Madoff operation at face value and rubber-stamped them. For this amiable activity, Friehling was paid between \$12,000 and \$14,500 monthly from 2004 to 2007. He agreed to cooperate with the prosecution in other Madoff-related cases, and as a result his



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sentencing was postponed (Bharara 2010). He faces the maximum possible statutory term of 114 years (Bray 2009, <http://tinyurl.com/8ho6r3x>).

Stanford Investment Bank

Madoff's Ponzi peer was Texas billionaire R. Allen Stanford, the 59-year-old head of Stanford International Bank (SIB). Along with his chief financial officer, James M. Davis, Stanford carried out what the SEC described as a massive, ongoing fraud. Like Madoff, he appears to have played fast and loose with auditing activity. The Stanford group is headquartered in St. John's, the capital of the island-nation of Antigua and Barbuda, a locale that fits the description novelist Somerset Maugham once applied to the French Riviera: "a sunny place for shady people."

Antigua has long been considered an attractive site for U.S. citizens who, illegally, pursue off-shore Internet gambling (Pontell, Brown and Geis 2007, <http://tinyurl.com/9zd23y7>). It was also the temporary refuge of Robert Vesco, who sought without success to buy the island of Barbuda from Antigua and thereby to avoid extradition to the U.S., where he

had been charged with egregious financial frauds (Herzog 1987).

SIB had sold approximately \$8 billion of what it called "certificates of deposit" to Central American and North American investors. Stanford was tripped up, ironically, when he claimed to have had nothing to do with Madoff. SEC investigators knew better, because they had learned that Stanford had deposited some of the funds invested with him in Madoff's company. So careless was Stanford that SIB claimed that its "diversified portfolio" had returned precisely identical results in consecutive years — a claim that an expert hired by the SEC labeled impossible.

Alex Dalmady, an investigative blogger, first exposed SIB in an article published in a Venezuelan financial magazine, *Veneconomy Monthly*. Dalmady titled the piece "Duck Tales," playing on the old saw that if something looks like a duck and quacks like a duck — or, analogously if things look decidedly crooked — then the former is a duck, and the latter is a scam (<http://tinyurl.com/9bsnnup>). Dalmady pointed out that the SIB auditor was an island firm whose principal was a 72-year-old man who had been examining the

company's books for at least a decade, despite the fact that PwC and KPMG both had offices in Antigua. Dalmady indicated that a Spanish proverb was appropriate to the Stanford situation: "Hecha la ley, hecha la trampa" — if there's a law, there's a loophole (Dalmady 2009, 14).

The SEC complaint briefly summarized the auditing farce that characterized Stanford's operation:

The impossible results are made even more suspicious by the fact that, contrary to assurances provided to investors, at most only two people—Stanford and Davis—knew the details concerning the bulk of SIB's investment portfolio. For example, its long-standing auditor is reportedly retained based on a "relationship of trust" between the head of the auditing firm and Stanford (SEC v. Stanford International Bank, Ltd. 2009, 2, <http://tinyurl.com/d6jyra>).

An autopsy on Arthur Andersen

The cozy relationship between the Enron Corporation and Arthur Andersen, LLP, its auditor and consultant, may have made for jolly social events and interchangeable job movement between the two companies, but it also contributed significantly to the demise of both organizations (Squires et al. 2003; Swartz and Watkins 2003; Toffler and Reingold 2003). It's arguable whether the prosecutors inflicted what reasonably could be regarded as a death penalty upon the companies or whether their departure from among the living was a matter of suicide.

Arthur Andersen, a limited partnership, was founded in 1913. By 2000, it was one of the "Big Five" as the auditing kingpins were known from 1989 to 1998. Andersen had worked for and with Enron since 1985 and at the end was receiving \$52 million a year in auditing and consulting fees from Enron, its major client.

In time, government authorities essentially got fed up with Arthur Andersen's repetitive wrongdoing. In 1997, the company had been the defendant in more



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than 30 lawsuits regarding advice it had provided investors who lost hundreds of millions of dollars following the collapse of Colonial Reality in West Hartford, Conn. Andersen paid out more than \$90 million to settle the case. A year before its troubles regarding Enron, the auditing company paid \$110 million to settle a class action suit brought by shareholders of Sunbeam.

Andersen's accountants also had failed to detect a Ponzi scheme run by the Baptist Foundation of Arizona. That cost the firm \$217 million to settle claims. Then there was a \$229 million payment in a 2001 suit involving an earnings statement by Waste Management that Andersen had "knowingly or recklessly" inflated by \$1.4 billion by recourse to unacceptable accounting methods (Laufer 2006, 45).

The SEC director of enforcement, Richard Walker, noted that the Waste Management law breaking was rooted in the fact that "Arthur Andersen and its management failed to stand up to company managers" (Laufer 2006, 45). As part of that settlement, Andersen was enjoined against engaging in such behavior. The U.S. deputy attorney general noted that in finally deciding to prosecute Andersen criminally, his office had taken into account many considerations, "including the seriousness of the alleged offense" and "the firm's history of wrongdoing" (Laufer 2006, 45).

The prosecution of Andersen for its work with Enron chose to focus on the shredding of relevant papers in Andersen offices in Houston; Portland, Ore.; Chicago and London after its attorneys and managers had learned that the government was suspicious of Enron. More than a ton of documents were destroyed as well as some 30,000 emails and computer files (Chase 2003).

After Andersen lost the case, its clients fled to other firms, and the company went under. The episode demonstrates how vulnerable a company that depends on a reputation for integrity is to a shaming criminal charge (Chaney and Philipich 2002, <http://tinyurl.com/9szes3h>). The U.S. Supreme Court curiously ruled that Andersen had been unjustly convicted because the government hadn't adequately proven that the shredding was no more than a routine business activity (*Arthur Andersen LLP v. United States* 2005; Spalding and Morrison 2006, <http://tinyurl.com/8ukhrfw>). But it was too late: The Big Five was now the Big Four.

Stephen Rosoff and his colleagues aptly sum up the Enron-Andersen events this way: "The company now acknowledges that it made what it terms 'errors of judgment.' One could respond that wearing a striped tie with a plaid shirt is an 'error in judgment.' What Arthur Andersen did is a crime" (Rosoff, Pontell and Tillman 2007, 310).

A former employee offered a telling account of his experiences on his first job as an auditor for an Arthur Andersen team. Vincent Daniels, who later would make a killing betting short on the downfall of investment firms, was struck by the opacity of the books of the client Solomon Brothers. Neither he nor his Andersen colleagues could understand what Solomon was doing and why it was doing it. He concluded that there was no way for an accountant assigned to such a task to determine accurately whether the company was making money or losing money, that their books were giant black boxes with hidden gears that were in constant motion. His manager, who had no better comprehension of the true picture, finally told Daniels to stop asking questions and just do the best he could, that that was what he had been hired for (Lewis 2010).

This brief vignette, multiplied many times, lies behind the recent observation of Richard Posner, a conservative federal judge and highly regarded economist: "accountants, since they are paid by the firm they audit, are reluctant to flag their clients' default risks. Granted, often those risks are not disclosed in the documents the accountants review in an audit, but sometimes they are" (Posner 2009, 94).

Posner's observation that companies often camouflage information so accountants are unable to make accurate assessments of the true state of financial conditions comport with the above-cited lament by Vince Daniels in his effort to audit Solomon Brothers; this theme often echoed.

We're faced with the inevitable question: Why bother at all with an "independent" external audit of a corporation? On

the upside, it seems very likely that some corporations some of the time (especially, perhaps, when those times are prosperous) go out of their way to offer honest appraisals of their financial condition and operations. But the naysayers routinely emphasize that an outsider who depends on the accuracy of the external auditor's examination in regard to the true condition of a company will be gulled if the company chooses to conceal relevant facts. The auditor's report then becomes no more than a fig leaf. It seems obvious that a better way of dealing with such situations is required. Or, as some say, perhaps consideration ought to be given to abandoning the practice altogether.

As disturbing as the Arthur Andersen revelations were, more fuel was added by a study that concluded that Andersen was no worse than the handful of other accounting firms who were responsible

for external audits of almost every large corporation in America. Thomas Eisenberg and Jonathan Macey, using selected restatements from 1997 to 2001 as a gauge of auditing malfeasance, concluded that "firms will capture the teams of auditors assigned to prepare financial statements, and cause these accountants to acquiesce in inappropriately [*sic*] accounting treatment, or even to pro-actively participate in the design of materially misleading accounting statements." More to the point, Andersen's clients' restatement rates were statistically no different than other firms (Eisenberg and Macey 2004, 264, <http://tinyurl.com/9ubjmag>).

Eisenberg and Macey found no evidence that the accounting firms compete with one another in regard to the quality of their work. Part of what reasonably can be seen as emergent and growing efforts to reduce litigation costs among external

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auditors is attributed to the move toward limited liability partnerships. Without this arrangement, the partners themselves could have been held personally liable in lawsuits, a situation that could have made them, according to the authors, a good deal more careful and encouraged them to more scrupulously monitor the work being conducted by every member of the firm. ■ **FM**

In part 2: External auditors' failures in major cases that predated the Great Economic Meltdown plus Sarbanes-Oxley and Dodd-Frank.

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