Should we Expand the Role of Auditors in the Financial Sector?
An evaluation of auditing in the Financial Crisis

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ISAR, Singapore, 24 June 2010

I was asked to talk today about the pros and cons of regulating auditing. I have taken some freedom in my response to this question and decided to provide an evaluation of the role of auditing in the financial crisis. In that evaluation I will specifically address calls for regulations expanding the role of auditors in the financial sector. These proposals concern mainly a wider role for auditors to provide assurance on information relating to risks, controls and governance.

My contribution can be considered to be a brief mid-term evaluation of the role of auditing in the financial crisis. The financial crisis started in the second half of 2007 and a mid-term evaluation suggests that the financial crisis has about three more years to go. Given the recent developments at stock markets this might look pessimistic. However, as a regulator I like to err on the conservative side and I would like to note that there are many examples in history of financial crisis that took longer than six years. I am convinced that the length of this crisis is affected by the policy decisions we take, including policies in the accounting and auditing area.

What is my main message today? Let me start by emphasizing that this crisis is not an accounting or audit crisis. While it is good news that auditors are not at the center of this crisis, there have been serious shortcomings in their performance. In the core of the auditors' mandate there have been problems with the quality of audits of financial institutions. For example, there have been shortcomings with auditing the valuation and disclosure of financial instruments. Outside their core mandate, you can be even more critical about the role of auditors in the financial crisis. In many countries auditors of financial institutions have the obligation to inform banking regulators if they observe any serious problems in the areas of governance, controls and going concern. This warning system has not functioned properly.

Given this background of shortcomings in the audit function in the financial crisis, we should be careful to further expand the role of auditors in new directions. Transparency for investors regarding the performance and position of financial institutions is a crucial requirement for steering out of this crisis. The recent calls for the publication of stress tests of banks illustrate the demands for more transparency in the financial sector. In this context it is probably needless to say that the auditors' clients have the prime responsibility for transparency on their financial performance and position. However, the work of the auditor provides assurance that financial reports meet the regulatory requirements regarding transparency.

Considering the complexity of clients in the financial sector, it is no surprise that conducting audits that result in transparent financial reports is very difficult and needs all resources and expertise available within audit firms. It is important for auditors to focus on this tall order. Further, the proposed new role for auditors mainly concerns reporting to boards of supervisors and banking regulators on risks, controls and governance. However, if these proposals are considered, it is equally important to provide this type of information to investors. This will reinforce the obligations of auditors towards investors and the wider public.

In my contribution I will first talk about the findings from inspections of audits in the financial sector. Then I will talk about the regulatory responses to the financial crisis at a European Union level. Regarding the international level I will briefly describe the activities in response to the crisis of the International Forum of Independent Audit Regulators (IFIAR). Then I will talk about the influence of banking regulation and governments on accounting and auditing. I will conclude with suggestions for the way forward.

The Quality of Audits in the Financial Sector

Most analyses of the causes of this financial crisis focus on issues like high leverage, poor business models, inadequate risk management, weak oversight and regulatory competition. Hence, this crisis is not at all comparable to the crisis at the beginning of this century, where fraudulent accounting and ineffective audits played an important role. That crisis, which was related to the bursting of the internet bubble, resulted in the establishment of independent auditing oversight in many countries across the world.

While this is not an accounting or audit crisis, serious shortcomings have appeared from independent inspections of the work of auditors. In December 2009 the AFM has publicly reported on their inspection findings of audits in the financial sector. The AFM identified relevant shortcomings in 11 of the 18 audits of Big Four firms which were reviewed. These shortcomings mainly concern insufficient audit evidence in relation to financial assets. One of the most important weaknesses identified is that external auditors did not sufficiently demonstrate the required professional skepticism. Exercising professional skepticism means amongst others that the auditor critically assesses the value of evidence that is in conflict with, or raises questions regarding, the reliability of documents, and information obtained from client management.

In addition to professional skepticism, there were findings regarding:

- Auditing the valuation of financial assets;
- Auditing the disclosures on uncertainties in determining the fair value of financial assets;
- The role of the group auditor; and
- Documentation.

In response to the quality problems identified, various measures were taken, including:

- The deregistration of certain external auditors from the public AFM register;
- Changes in the composition of management and/or staff of Financial Services Departments; and
- Additional audit work and correction of errors in financial statements.

The problems mentioned are consistent with various empirical studies which show that write-downs of financial instruments on banks' balance sheets have been slow and lagging compared to decreasing credit indices and stock prices. Examples of these studies are Huizinga and Laeven (2010) and Vyas (2009).

In many countries, the mandate of auditors of financial institutions is not limited to providing assurance on the financial statements. Frequently the auditor has also a role regarding the banking regulator. For example, in the European Union there is the requirement that the auditor needs to alert the competent authorities when he becomes aware of facts that have a serious effect on the financial situation of an institution. Regarding this role, the European Commission recently concluded bluntly that this requirement has not been effectively enforced.

The Regulatory Response
There have been a large number of regulatory responses to the financial crisis that have an impact on auditing. I will look at three areas: the response at a European level, the activities undertaken by the International Forum of Independent Audit Regulators (IFIAR) and finally I will specifically look at the effects of increasing attention for accounting and auditing from banking regulators and governments.

European Regulatory Response
In response to the financial crisis, no major new steps were taken by the European Union that directly impact on auditing and auditing oversight. In the past years most Member States were still in the process of implementing the 8th Directive of 2006, which requires the establishment of independent oversight. However, in three closely related areas major steps were taken that indirectly impact on auditing. Recently the first steps were taken for truly European oversight in the areas of banking, insurance and the securities industry. A European System of Financial Supervisors (ESFS) will be established, consisting of a network of national financial supervisors working in tandem with European Supervisory Authorities (ESAs). For each of the three areas, an ESA will be established. The ESAs will be Community bodies and will take on all the tasks of the existing European supervisory committees. In addition, they will have significantly increased responsibilities, defined legal powers and greater authority. Moreover, they will have the possibility of charging fees. Hence, the ESAs are the start of truly European oversight in banking, insurance, and the securities industry. The establishment of the three ESAs is one of the positive results of the political momentum created by the credit crisis.

I hope that as soon as possible these steps will be copied for the auditing area and that the fourth ESA will be the European Auditing Authority (EAA). The EAA could work in tandem with a network of national auditing regulators. The need for this step is obvious: auditing is one of the most important pillars for well-functioning banking, insurance and securities markets. The EAA should be given the responsibility for the authorization and supervision of certain audit firms with pan-European reach. This is especially relevant for networks, like Ernst & Young and KPMG, which have established legal entities bundling their activities in more than one Member State of the European Union. The responsibilities could include such powers as those of on-site inspections, supervisory decisions, and investigation. Apart from reinforcing the effectiveness of supervision, this could enhance efficiency by creating a 'one-stop shop' for supervised audit firms.
From the recent announcement by EU Commissioner Barnier that he will publish a so-called Green Paper on auditing in the Fall of this year it is clear that the Commission considers steps in the direction of European-wide oversight of audit firms. In addition to this topic, the announcement by Barnier covers a wide range of issues in the auditing area. Referring to the Lehman Brothers case, the European Commission states that it is also desirable to look at the role of audit in the financial crisis.

International Regulatory Response: IFIAR
There are a number of activities that the International Forum of Independent Audit Regulators (IFIAR) has undertaken in response to the financial crisis. One of the Working Groups of IFIAR concerns the dialogue with the largest six international networks, the so-called GPPC (Global Public Policy Committee) networks. As you are probably aware, national independent audit regulators regulate and oversee the national firms of the networks but have no, or a limited mandate regarding the international networks themselves. However, the international networks are very important for the national activities inspected by IFIAR members. Therefore, IFIAR initiated this dialogue with the GPPC.

In 2008, IFIAR held a round of sessions with each of the six networks to obtain a better understanding of their responses to the financial crisis. These responses concerned both their audits and their broader network strategy.

In addition, IFIAR members have identified persistent audit problems that appear from their inspections. Four issues identified concern professional skepticism, revenue recognition, second partner review, and the role of the group auditor. While all four issues are relevant for audits in the financial sector, they are generic and also apply outside the financial sector. In March this year IFIAR discussed with the GPPC the responses by the networks to the four issues identified and possible actions they can take. In the year ahead, IFIAR will continue the dialogue on the four issues with the GPPC.

The Influence of Banking Regulation and Governments on Accounting and Auditing
One of the results of the financial crisis is that accounting and auditing have received much more attention from banking regulators and governments. On the accounting side there have been calls to reduce the application of fair values and that accounting standards should give more weight to prudential objectives. As a result, the value of financial statements for banking regulators would increase. On the auditing side there have been calls for a wider role of auditors regarding the risks, controls, and governance of financial institutions. I will now discuss these two developments.

Regarding the first, the attention from banking regulators and governments is mainly a negative one: fair value accounting is considered to be one of the problems of the credit crisis. It is claimed that fair value accounting has resulted in a negative spiral of impairments of assets and deteriorating market prices. Consistent with this, banking regulators and governments have pressed for reducing the use of fair values in financial reporting. Also, there have been strong appeals from both the banking sector and governments that accounting standard setters should give greater weight to prudential objectives.

The decision regarding the right mix of fair value accounting and historical cost accounting is a complex one. While there is evidence that we should not expand fair value accounting to all asset and liability classes of financial institutions, there is no evidence that fair value as it is applied in the current mixed model has worsened the financial crisis. This point is made convincingly in a study by Laux and Leuz (2009). However, the really important issue is not the effect of fair value accounting on the financial crisis, but the issue regarding the objectives of financial reporting.

The main objective of financial reporting is, and should be, providing transparency on financial performance and positions to investors and the wider public. Without transparency, investors will lose their confidence in financial reporting. While in general transparency also serves the prudential perspective, exceptionally this is not the case: if the financial conditions of a bank are very poor transparency might initiate a bank run.

I am concerned about mixing transparency and prudential objectives in financial reporting. These risks can be illustrated with a study by Skinner (2008) regarding the financial crisis in Japan in the 90s. During that crisis, various changes in accounting standards were inspired by prudential considerations. The accounting changes allowed banks to artificially increase their regulatory capital and to mask their extremely poor financial position. These so-called “zombie banks” delayed their restructuring, and had strong incentives to continue providing credit to poorly performing companies. According to Peek and Rosengreen (2005) this practice has had a systematic negative impact on the performance of the Japanese economy and has prolonged the Japanese financial crisis.

Now let's discuss the second development: the calls for a wider role of auditors in the financial sector. The proposals for a wider role concern such issues as providing information and assurance on risks, controls, and governance. In most cases the proposals focus on providing this information to the board of supervisors and banking regulators. For example, one of the suggestions by the European Commission in a recently published Green Paper on Corporate Governance in Financial Institutions concerns "... extending the reporting scheme by which external auditors alert the board of directors and supervisory authorities of any substantial risks they discover in the performance of their duties ('duty of alert')...".

I am concerned about these proposals. One concern, as I stated earlier, is that conducting audits that result in transparent financial information is a tall order, and auditors still have a way to go. They need a clear focus to accomplish this objective successfully and new tasks will make it difficult to stay the course. My other main concern with the proposed new role of auditors can be illustrated with a discussion I had with the leadership of a large audit firm network. On the question how they responded to the credit crisis they stated that "... they stood ready to help their clients through this difficult period". While this sounds sympathetic, there is a risk attached to this perspective. For reliable financial reporting it is important that audits contribute to transparency, both in good times but also in bad times. Hence, an auditor should always strive for transparency, even when it concerns the viability of the client. The fact that we have seen failures of financial institutions without going concern warnings confirms that auditors are reluctant to publicly report serious problems regarding the financial position of their clients. Regulatory proposals whereby important information is exchanged between the auditor, the supervisory board and prudential regulators, but not with investors, will reduce the relevance and reliability of financial reporting.

The Way Forward

Looking forward I conclude that a better performance is needed to meet expectations regarding the audits of financial statements in the financial sector. To meet these expectations auditors need to be fully aware that their real clients are the investors and other users of financial reporting. Also, conducting audits that result in transparent financial reporting is not an easy task. It requires auditors with extensive expertise in the financial sector, who understand the risks and environment of their clients and demonstrate professional skepticism. To accomplish this the leadership of the large international networks should give the right example.

For any possible new task for auditors in the financial sector we should be convinced that it is consistent with, and contributes to, transparent financial reporting. Hence, if auditors need to provide more information on risks, controls and governance, that information needs to be communicated with the supervisory bodies, the banking regulators, and investors. While transparency in the short term might have uneasy consequences, in the long run it is a requirement for reliable reporting.

Thank you

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