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The auditor's role in the economic recession

I started as a regulator of securities trading and auditing in September 2007, one month after the eruption of the financial crisis. In the following two years I have, to my own surprise accumulated a number of positions in the fields of accounting and auditing. I became co-chair of the Financial Crisis Advisory Group, advising the IASB and FASB on the consequences of the financial crisis; I became chairman of the Monitoring Group, providing oversight of the PIOB and I became chairman of the Monitoring Board, providing oversight of the IASCF and its activities. Should anyone decide to found another Monitoring Body, I will undoubtedly end up chairing that too!

This accumulation of positions would at first sight indicate a wide and deep experience in the field of accounting and auditing on my part. Nothing, however, could be farther from the truth. As a trained historian and former politician, I have relatively little experience in these fields. However, being a layman in the wondrous world of auditing and accounting has huge benefits. It forces you to concentrate on the big issues and not to get lost in detail. And boy, it certainly is very easy to get lost in the detail and complexity of accounting and auditing rules. In a world heavily dominated by well trained (perhaps even over-trained) professionals there is always a very big danger of everything getting way too complex. Keeping things simple is a virtue that professionals, whether they be doctors, auditors, or indeed supervisors, such as myself, tend to forget. Yet the more complex problems become, the more important it is to keep your eye on the big issues, which are usually surprisingly simple. I will come back to this issue when I discuss the credit crisis and the role of auditors.

But first let me tell you a little bit about my organisation and the role of supervision in general in the field of auditing. In the Netherlands we have split the supervision of the financial markets in two parts. The Dutch central bank is the prudential supervisor. It is responsible for keeping banks and insurers financially healthy by monitoring their capital positions.

The AFM is the conduct of business supervisor for the entire financial market sector in the Netherlands: savings, investment, insurance and loans. By supervising the conduct of business of the financial markets, the AFM aims to make a contribution to the fair and efficient operation of these markets. In essence we serve to protect the interests of investors and consumers in the financial markets.

Our specific oversight on Audit Firms not only applies to the audit of Public Interest Companies but to *all* Dutch statutory audits. All audit firms/licensees and especially firms that have an impact on the audit market - like DFK - have been thoroughly examined by the AFM, as mr. Harry van Houts should be able to confirm.

Historically, the audit profession has had a long tradition of self regulation. Only after the events in the early years of this century, i.e. Enron, Worldcom, Parmalat and, right here in The Netherlands, Royal Ahold, the regulatory framework has been reshaped. In many jurisdictions, independent audit oversight has been set up or is in the process of being set up. The AFM’s managing director Steven Maijoor currently is Chairman of IFIAR, the collective body of the audit regulatory community, which underscores that not only I as a person, but the whole AFM is strongly committed to auditing.

As I said, in the Netherlands, the role of oversight is no longer a territory for self regulation. Since October 2006, the AFM regulates and oversees the market for and the conduct of statutory audits. In light of the economic crisis, we have performed our first inspections on the 2007 financial statements for financial institutions. In these inspections, we noted a number of vulnerabilities.

As the formal reporting of these inspections has not been fully finalized, I cannot say too much on these, but it is worthwhile noting that we have drawn attention to the areas of the role of the group auditor, the valuation of financial assets (including special value adjustments), the explanation of uncertainties in the annual accounts and the documentation of the audit in the audit file of the auditor. We have already commenced a second series of inspections, again focusing on the risky areas due to the economic crisis, and we expect the firms have learned from our findings.

This brings me to make some more general observations on the role of auditors in the economic recession that currently grips the world.

Looking back

As you all know the current economic crisis started with the credit crunch that erupted in the summer of 2007. This credit crisis evolved into a financial crisis with collapsing banks and an ongoing increasing number of bankruptcies in the real economy, including classic institutes like

General Motors. In the process, fraud of an unbelievable scale, such as Madoff and other Ponzi-schemes, came to light. Today, the world is in an economic recession and no one knows for sure how deep it goes and how long it will last.

Meanwhile everybody is looking for an explanation for the financial crisis and for who is to blame. The same question is being asked over and over again: Bankers, Securities regulators, Credit Rating Agencies, Analysts, Governments and Auditors; Where were you and why didn’t you see it coming?

An excuse that you hear a lot is that the financial world had become so complex, that for most market participants it had become impossible to assess the risks embedded in the system. To some extent that is true, although it should be said that the very complexity of the system was a red flag in itself.

But the most surprising thing was that the biggest risks were easy to see and that almost no one saw them! The basic cause of the crisis was the over-indebtedness of the economy as a whole and the leverage of the financial sector in particular. In many areas of the world, the combined levels of indebtedness of consumers, companies and the state had never before been so high. Relative to gross domestic product the level of debt about tripled as compared to the level we had in the eighties. There was concern about this, but not nearly enough. Looking back, it is clear that the whole economy had become a huge pyramid of debt, that at some point inevitably had to come tumbling down.

Even more surprisingly, banks were allowed to build up debt levels that were 25, 30 or even more times their tangible common equity. What were we thinking? Was no one aware that a mere 2 or 3% decline of the asset value of banks would be enough to wipe out their entire equity?

This is a question that can be asked to supervisors, but also to preparers and auditors. Shouldn't they have blown a whistle when they saw financial institutions becoming overly leveraged? Why didn't they raise going concern

flags? I know this is extremely tricky in a field where any red flag can lead to a bank run. It also needs to be said that one cannot expect auditors to second-guess the markets when 99% of trained economists were unaware of the fact that the financial markets were built upon quick sand.
Still, auditors might have seen more if they had concentrated more on the big picture and less on technical detail. Also, it is highly recommendable that auditors and prudential regulators intensify their communication in the future. If auditors cannot raise their concerns in public, they should be able to do so with the regulators.

Auditors play a key role in providing reliable financial reporting and transparency.
The Audit profession now has a golden opportunity to validate its existence by showing its value to the financial markets. In times of prosperity audit failures may not be noticed. These days failures may be fatal, both to clients and audit firms. Now is the time for auditors to stand firm and to regain the trust that was lost.

More generally, the current crisis demands more vigilance on the part of auditors. On the one hand, markets, more than ever before, need transparency in terms of reliable financial reporting. On the other hand, more than ever the market is facing the classic dilemma of transparency. What will happen when the losses are shown? Will it be the end of my business? Will it be the end of my audit client? There are lots of pressures to violate transparency. Many companies will have a tendency to overstate revenue and income in order to meet bank covenants and to survive the crisis. In other words cooking the books.

Reliable financial reporting, however, is crucial for all stakeholders. In the end everyone loses when financial reporting is based on going concern when in fact the client is technically bankrupt. If only the auditor had refused to give an unqualified opinion…

What we see is that audit firms are well aware of the momentum. Audit firms are putting all kinds of additional checks and balances in place. These include consequences for auditors that don’t comply. Besides, audit firms are well aware that the market will be looking for opportunities to hold audit firms liable. Therefore audit firms make sure that they cover specific risks that relate to their clients. In the light of the economic crisis these risks relate to going concern, fair value accounting, impairment testing, the pressure to perpetrate fraud, and risks that relate to specific industries like Finance, Real Estate, Construction, Transportation, Automotive and Consultancy.

A specific area of attention to us and other regulators is low balling. Clients use the economic recession as an argument to put pressure on audit firms to lower their audit fees. In itself, it is perfectly fine that companies try to keep auditing fees low. Auditing is expensive, which has a lot to do with the oligopolistic nature of the market. Competition is healthy and shopping around for lower fees is perfectly legitimate.

So there is probably room for lower fees but this should not go at the expense of the quality and breadth of auditing. In our view the economic recession will in many audits demand rather more work to be done and will therefore leave little room for lower audit costs. In many cases auditors will need to challenge going concern. As a consequence the auditor at least will need to review recent monthly financial results and will need to challenge cash flow forecasts and refinancing arrangements. Another example of more audit work is impairment testing because of triggering events as a result of the economic crisis. Bottom line was and still is the question whether the auditor collects sufficient and appropriate audit evidence and that the auditor maintains an attitude of professional skepticism in doing so. In other words, Trust is good, verification is better!

I shared with you my views about the auditor’s role in the economic recession. I also shared some views about other participants’ roles in the economic recession, including the role of the AFM and other regulators. All parties have an important role to play. Let’s make sure that we all follow up on our responsibilities. Thank you for your attention.