**Congress Probes Accountants’ Role in Financial Crisis**

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By Michael Cohn, Accounting Today

Congress held a hearing Wednesday on the role of the accounting profession in preventing another financial crisis, listening to testimony from accounting regulators, standard-setters and critics.



James Kroeker

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“There is reason to consider the extent to which improper, fraudulent, or inadequate financial reporting relating to GAAP reported results or to disclosures outside of the audited financial statements played a role in the financial crisis,” said SEC Chief Accountant James Kroeker in his prepared testimony before the Subcommittee on Securities, Insurance, and Investment of the Senate Committee on Banking, Housing, and Urban Affairs. “SEC enforcement teams continue to pursue cases stemming from actions that contributed to the financial crisis, following settled enforcement actions involving Countrywide Financial, American Home Mortgage, New Century, IndyMac Bancorp, and Citigroup. When poorly performed audits contribute to or fail to detect financial reporting abuses, there are existing mechanisms for dealing with such misconduct, including SEC or PCAOB enforcement actions. For our part, we will continue to prosecute those who fail to comply with their obligations.”

Anton Valukas, the bankruptcy examiner in the Lehman Brothers bankruptcy, told the committee about his report on Ernst & Young’s audits of the failed investment bank, but he cautioned, “I want to emphasize at the outset that I did not make any finding as to whether regulators or auditors necessarily could have prevented Lehman’s collapse. Lehman failed in part because it was unable to retain the confidence of its lenders and counterparties and because it did not have sufficient liquidity.”

“Nevertheless, and wholly apart from the claims involving Lehman’s auditors, we must recognize the general principle that auditors serve a critical role in the proper functioning of public companies and financial markets,” Valukas added. “Boards of directors and audit committees are entitled to rely on external auditors to serve as watchdogs – to be important gatekeepers who provide an independent check on management. And the investing public is entitled to believe that a “clean” report from an independent auditor stands for something. The public has every right to conclude that auditors who hold themselves out as independent will stand up to management and not succumb to pressure to avoid rocking the boat.”

Financial Accounting Standards Board chair Leslie Seidman discussed the role of FASB in the standard-setting process and referred back to the controversy over mark-to-market accounting. “As the credit and financial crisis deepened and broadened in late 2008 and early 2009, significant attention was placed on ‘mark-to-market,’ or fair value, accounting, including the effect of applying the fair value standard to report the value of impaired securities,” she said. “The controversy reflected, in part, the difficulty of determining the fair value of assets or liabilities in illiquid markets. It also reflected the concern that the accounting for problem assets held by financial institutions, including loans, was ‘procyclical’ and may have exacerbated the crisis (even though loan losses are generally not measured at fair value).”

Former SEC Chief Accountant Lynn Turner emphasized that auditors did not create the financial crisis, but they did have an extremely important role to play as gatekeepers to the capital markets in the U.S. and abroad. “Gatekeepers including the auditors did play a role in the financial crisis,” he added. “They failed to act on and provide information available to them to investors. This left investors much like the ship Titanic as it approached an unforeseen iceberg, without any red flags or warnings of the imminent dangers. In doing so, the auditors helped contribute to a crisis in confidence.”

Cindy Fornelli, the executive director of the Center for Audit Quality, agreed that auditors did not cause the financial crisis. “Following the past several years of global economic turmoil, there have been extensive examinations by panels and commissions to identify the root causes of the financial crisis and determine what could be done to reduce the risk of a future similar crisis,” she said. “While none of the panels or commissions found that auditing was a root cause of the financial crisis, auditors, like all participants in the capital markets, have a responsibility to examine their role in light of lessons learned from the crisis and consider what improvements can be made in audit standards and what more they can contribute to market integrity and investor protection.”

Thomas Quaadman, vice president of the Center for Capital Markets Competitiveness at the U.S. Chamber of Commerce argued for less reliance on prescriptive rule-making by standard setters and greater transparency. “For decades, standard setters have been operating under inadequate rules and guidance, resulting in the impairment of financial reporting and as a contributing factor that escalated the financial crisis,” he said. “In order to prevent the next crisis we must address the fundamental flaws with the system.”

Public Company Accounting Oversight Board chairman James Doty urged Congress to amend the Sarbanes-Oxley Act to allow for public disciplinary hearings of auditors. “The auditors and audit firms charged with violating applicable laws, rules or standards have little incentive to consent to opening the case against them to public view and in fact, none have ever done so,” he said. “On the contrary, the fact that, absent consent, PCAOB disciplinary proceedings are required to be secret creates a considerable incentive to litigate. PCAOB disciplinary proceedings remain non-public even after a hearing has been completed and adverse findings made by a disinterested hearing officer, if the auditors and firms do not consent to make the proceedings public and opt to appeal. Litigation postpones — often for several years — the day on which the public learns that the PCAOB has charged the auditor or firm, the nature of those charges, and the content of adverse findings… This state of affairs is not good for investors, for the auditing profession, or for the public at large.”