Auditors and the Financial Crisis of 2007–2009

In a period of extreme market volatility, the public company auditing profession steadfastly carried out its responsibilities, maintained dialogue with regulators, and applied lessons learned.

From 2007 to 2009, economies and markets across the globe suffered severe and protracted downturns. According to Former Federal Reserve Chairman Alan Greenspan, it was “by far the greatest financial crisis globally ever.” Greenspan's successor, Chairman Ben Bernanke, characterized the months of September and October 2008 as "the worst financial crisis in global history," noting that of the 13 “most important financial institutions in the United States, 12 were at risk of failure within a period of a week or two.”

During these difficult times, accountants and auditors, in the words of one observer, "rose to the occasion." While not without missteps in an extremely challenging environment, the auditing profession, working with its regulators, was proactive as the market maelstrom occurred. In its aftermath, the profession studied lessons learned and helped to advance proposals that would address key challenges that arose during the crisis.

The Economic and Market Drivers of the Crisis

To understand auditors and the financial crisis of 2007–2009, a good starting point is to examine what caused the downturn. While historians will continue to scrutinize and debate top factors, a look at the crisis timeline indicates that the primary drivers were economic and market forces—and not accounting scandals (e.g., the failures of Enron or Worldcom) or, as observed in this staff report from the US Securities and Exchange Commission (SEC), fair value accounting practices.

In short, easy access to seemingly inexpensive credit to fund an increasing supply of residential housing—coupled with the proliferation of innovative financial instruments, as well as lax loan underwriting standards and documentation—led to an asset bubble that burst.

This economic reversal was marked by a breakdown in risk management at many levels.

- Consumers took on too much debt.
- Lenders issued high-risk mortgages that were packaged and resold.
- Lenders held large amounts of risky, leveraged instruments.

- Investors purchased complex securities that they did not understand.

All these factors fed into a crisis that was in turn exacerbated by unprecedented levels of interconnectedness in the global financial system.

Understanding the Role of the Auditor

Could auditors have prevented this crisis? Was it their job to do so? In a word, no.

Auditors were not responsible for "enforcing good risk management practices at financial institutions," observed James Doty, Chairman of the Public Company Accounting Oversight Board (PCAOB), in a 2011 speech on the auditing profession during the crisis.

Or consider 2011 testimony from James L. Kroeker, then the SEC's Chief Accountant. "While auditors must understand these risks to the extent that they impact financial reporting risk," he said, "the auditor's procedures and communications are not designed to specifically address risks other than financial reporting risk or to make judgments about the merits of a company's business strategies." An audit, Kroeker added, "is not designed, nor can it or should it be designed, to take all risk out of investing."

Kroeker's testimony echoes 2010 observations made by the UK's financial regulator, the Financial Reporting Council (FRC). In a comment filed with the European Union, the FRC noted evidence of "an expectation gap between the actual scope of an audit and public perception of the information an audit should reveal." The FRC observed that "the primary purpose of an audit is to provide independent assurance to shareholders that the directors have prepared the financial statements properly." An audit does not exist, it continued, "to provide general comment or opinion on a company's business model."

How the Profession Stayed Proactive During the Crisis

Auditors may not have been responsible for companies' business models or risk management, but that didn't mean that they sat on their hands during the crisis. To the contrary, the profession was highly proactive and engaged with its regulators as events unfolded.

This activity was documented by the PCAOB in a 2010 report with observations from the crisis. It noted that its inspectors "observed that firms responding to the increased risks resulting from the economic crisis took various actions, including issuing technical guidance, requiring additional training, developing new audit tools, requiring additional audit procedures, and increasing monitoring of audit engagement personnel."

For its part, the Center for Audit Quality (CAQ) and its Professional Practice Executive Committee prepared three white papers to assist auditors regarding critical topics: measurements of fair value in illiquid markets, consolidation of commercial paper conduits, and accounting for underwriting and loan commitments. While the white papers did not break new ground or establish new accounting or auditing standards, they highlighted key issues that needed focus and attention by the profession.

Lessons Learned from the Crisis

It's equally important to acknowledge that the public company auditing profession was not perfect during the financial crisis. The 2010 PCAOB report cited above noted a range of instances where audits reviewed by regulators showed deficiencies, particularly in crisis-afflicted areas such as fair value (or mark-to-market) measurements, impairment of goodwill, and off-balance sheet structures.

However, along with policymakers, the profession has worked assiduously to remedy deficiencies and to address the top issues that emerged from the crisis.

For example, the profession has been highly engaged in efforts to update the auditor's reporting model, providing robust and timely feedback on related proposals from regulators. Under these proposals, the auditor's report would provide more insight on issues (1) that are material to the financial statements and disclosures and (2) that involve especially challenging, subjective, or complex auditor judgment.

The issue of fair value measurements, so prominent during the crisis and its aftermath, has also been an ongoing priority for the profession. As the financial crisis waned, the CAQ, for example, highlighted the benefits of fair value accounting, while offering recommendations for improving its application. In 2015, the CAQ provided the PCAOB *Auditing Accounting Estimates and Fair Value Measurements: A Framework*, an effort reflecting input from across the profession.

While it may be impossible to avoid future economic and market downturns, one can only hope that the crisis of 2007–2009 will remain forever "the worst financial crisis in global history." Yet no matter how the economic winds blow, the public company auditing profession will stay firmly moored by its core principles, its constructive engagement with policymakers, and its drive to continually improve for the benefit of markets and investors.

About the Center for Audit Quality

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors’ objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, DC, the CAQ is affiliated with the American Institute of CPAs. For more information, visit www.thecaq.org.