

*re:*The Auditors

A summary of writing on AIG, Maurice “Hank” Greenberg, PwC as auditors of AIG, and AIG’s relationship with Goldman Sachs during the financial crisis era.

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PwC and AIG – Way Past The Time To Resign

Jun 20th, 2007



The Compliance Week 2007 agenda included an interesting panel on [Proxy Issues](#), hosted by Louis Thompson, a Compliance Week columnist and former president and chief executive of the National Investor Relations Institute. Panelists were the founder of The Corporate Library, Nell Minow, Laurence Hazell from Standard & Poor's, Kenneth Bertsch of Morgan Stanley Investment Management, and Institutional Shareholder Services Vice President Patrick McGurn.

Per the panelists, the top issues that saw a flurry of activity this year, (shareholder votes on executive compensation or "Say-on-Pay", majority voting to elect directors, and broker voting) will resurface in 2008.

My question related, of course, to the rote, mechanical way companies propose and re-appoint their external auditors. We've had so many issues with auditors and the conflict of interest and lack of independence that occurs when they are

investigated along with a company's management or, worse yet, sued by the company and/or its shareholders.

Why, I asked, was the process for proposing and appointing the external auditor still such a non-transparent process? Why don't the companies and shareholders sever relationships with audit firms that have steered them wrong or not prevented them from going down the wrong course and, therefore, subjected them to restatements and worse?

McGurn answered first and too quickly. He thought I was asking for all companies (or the PCAOB) to blacklist an audit firm that had been sued from auditing any other company. He started shrieking about another Andersen and too few to fail and KPMG's reprieve before Laurence Hazell interrupted him and added some wise, measured comments. Mr. Hazell agreed that it was about time investors and proxy advisors started to look at this issue.

My next question is: Where is the SEC on this issue? When will they force the Big 4 to publicly disclose [how much they have in reserve](#) to protect the investor public, their other clients, their employees and partners, their business communities and their vendors from a [nuclear bomb](#)?

As we've seen, the auditors hang on to the relationships, even with all their talk of risk management and protection from litigation and catastrophic liability, until the last minute, before finally quitting or being fired. Maybe they need protection from their own greed and hubris?

Every Big 4 firm has been in this situation:

- KPMG with [New Century](#) and [Fannie Mae](#), and [GE](#)
- PwC with [Tyco](#), [Freddie Mac](#) and [Dell](#),

- [PWC/KPMG with Collins & Aikman](#) and [Shell](#)
- E&Y with [Health South](#) and [American Express](#), and
- KPMG again still with [Siemens](#).
- [Deloitte with Adelphia](#), [Parmalat](#) and [Micrel](#).
- PwC again with [BearingPoint](#), and now,
- [PwC again with AIG](#).

[Greenberg sues AIG over derivative litigation](#)

*“Firing back at a \$1 billion lawsuit filed against him last week by his former company, Maurice R. Greenberg on Wednesday sued various current and former American International Group Inc. directors and management as well as the **insurer’s longtime auditor, PricewaterhouseCoopers LLP**“*

C. V. Starr Catches Up On PwC/AIG Conflict

Aug 16th, 2007

This conflict was identified [here](#) on June 20. Let me know where I can send the bill.

C.V. Starr seeks auditor change at AIG

*“PricewaterhouseCoopers L.L.P. should be barred as American International Group Inc.’s outside auditor due to **irreconcilable conflicts of interest**, a petition by C.V. Starr & Co. Inc. contends.*

The petition, filed with the Securities and Exchange Commission earlier this month, represents the latest move in a bitter feud between former affiliates AIG and Starr. Starr is led by former AIG Chairman and Chief Executive Maurice R. Greenberg.

*Starr—which, despite its severed relationship with the insurer, remains an AIG shareholder—alleges in its petition that AIG’s longtime independent auditor should be forced to resign because **an AIG special litigation committee earlier this year authorized shareholders to pursue a derivative action against PwC in Delaware Chancery Court.***

“AIG’s decision to have the derivative plaintiffs prosecute the claims against PwC on behalf of AIG instead of having AIG’s own counsel prosecute the claims cannot eliminate the conflict that exists,” the Starr petition says.

*Starr asks the SEC to call formal proceedings to determine PwC’s **independence.***

“We have full confidence in the independence of PricewaterhouseCoopers. We believe this petition is completely

without merit,” a spokesman for New York-based AIG said. “We did not authorize any claims against PwC.”

A spokeswoman for New York-based PwC said in a statement: “The firm is confident that it remains independent of AIG. Nothing in Mr. Greenberg’s ‘petition’ of two weeks ago causes us to change that view.” A representative of Starr, also of New York, declined to comment.”

Excellence Is Not An Act But A Habit

Sep 16th, 2007

Category: [AIG](#), [PricewaterhouseCoopers](#), [SEC](#)



“Excellence is an art won by training and habituation. We do not act rightly because we have virtue or excellence, but we rather have those because we have acted rightly. We are what we repeatedly do. Excellence, then, is not an act but a habit.”

-Aristotle

Although [I usually agree wholeheartedly with Jonathan Weil](#), I take exception to [his position](#) on the wisdom and the significance of [C.V. Starr’s petitioning of the SEC to remove PwC as AIG’s auditor](#).

As for PwC and the remaining defendants, AIG’s special litigation committee decided to take no position. When asked if the committee had “authorized” the plaintiffs to proceed against PwC — as C.V. Starr told the SEC — AIG spokesman Chris Winans said it hadn’t. Still, the practical effect is [the derivative plaintiffs can sue PwC if they wish](#).

“AIG has made it abundantly clear that they’ve taken no position with regard to PwC,” said Stuart Grant, whose law firm,

Grant & Eisenhofer PA, filed the derivative suit. He said the firm's lawyers are drafting an amended derivative complaint and "have not decided" whether it will name PwC as a defendant.

According to the SEC's rules, a derivative complaint against a company's auditor doesn't presumably cause an independence violation, unless the company adopts the suit as its own. Technically, AIG hasn't done that.

Jonathan: Don't shoot the messenger!

The essence of acting as an auditor of a public company is to instill confidence and a high level of comfort in the fair representation of the company's financial condition for the investors. It is as much about the appearance of objectivity and integrity in performing these duties as it is in the actual fact of objectivity and integrity.

A distinguishing mark of a profession is acceptance of its responsibility to the public. *The accounting profession's public consists of clients, credit grantors, governments, employers, investors, the business and financial community, and others who rely on the objectivity and integrity of certified public accountants to maintain the orderly functioning of commerce. This reliance imposes a public interest responsibility on certified public accountants. The public interest is defined as the collective well-being of the community of people and institutions the profession serves.*

*In discharging their professional responsibilities, members may encounter conflicting pressures from among each of those groups. **In resolving those conflicts, members should act with integrity, guided by the precept that when members***

fulfill their responsibility to the public, clients' and employers' interests are best served.

*Those who rely on certified public accountants expect them to discharge their responsibilities with integrity, objectivity, due professional care, and a **genuine interest in serving the public.***

As the [AICPA Standards, under Other Considerations](#), say:

*It is impossible to enumerate all circumstances in which **the appearance of independence might be questioned.** In the absence of an independence interpretation or ruling under rule 101 [ET section 101.01] that addresses a particular circumstance, a member should evaluate whether that **circumstance would lead a reasonable person aware of all the relevant facts to conclude that there is an unacceptable threat to the member's and the firm's independence.***

Specifically [with regard to litigation](#), the standards plainly say that independence can be impaired by both the effect of actual litigation between the firm and its client as well as, and this is the title of the section, **the effect of threatened litigation..**

The Standards also do address stockholder's derivative suits.

A covered member may also become involved in litigation ("primary litigation") in which the covered member and the client or its management are defendants. Such litigation may arise, for example, when one or more stockholders bring a stockholders' derivative action or a so-called "class action" against the client or its management, its officers, directors, underwriters and covered members under the securities laws. Such primary litigation in itself would not alter fundamental

*relationships between the client or its management and the covered member and therefore would not be deemed to have an adverse impact on independence. **These situations should be examined carefully, however, since the potential for adverse interests may exist if cross-claims are filed against the covered member alleging that the covered member is responsible for any deficiencies or if the covered member alleges fraud or deceit by the present management as a defense.***

So when PwC gets sued over AIG, and it's definitely when, not if, they will probably bring the, ["We were duped!" defense](#). That defense, which is the only one these days that the firms seems to be using, since it's [the defense of last resort](#), will put them in direct conflict with their client. The [**potential for litigation**](#) where their position is contrary to their current client, should be enough to cause them to resign, without anyone having to force them to do so.

[AIG Shareholders Sue PwC](#)

Oct 1st, 2007



[Source](#)

If we wait for the company or PwC to do the right thing, we'll be waiting all day. [Sorry Jonathan](#). Looks like PwC will [have to face the music](#), whether they like it or not. Maybe now [they'll resign?](#)

[UPDATE 1-AIG shareholders sue PricewaterhouseCoopers](#)

American International Group Inc shareholders renewed claims against the company's auditor, PricewaterhouseCoopers, and about four dozen other individuals and companies, seeking to hold them liable for a financial restatement and a \$1.64 billion regulatory settlement.

The derivative action — a claim brought by shareholders on behalf of a corporation — was filed in Delaware Chancery Court on Friday. AIG shareholders previously sued in 2004, naming former Chief Executive Maurice “Hank” Greenberg, former Chief Financial Officer Howard Smith, PwC and others as defendants. In the amended complaint, filed on Friday, the shareholders seek damages from PwC and others, including Marsh & McLennan Cos Inc (MMC.N: [Quote](#), [Profile](#), [Research](#)), ACE Ltd(ACE.N: [Quote](#), [Profile](#), [Research](#)), and several current and former AIG directors and officers.

In June, AIG took over the shareholders' lawsuit against Greenberg and Smith, becoming sole plaintiff in the case and leaving shareholders to decide whether to pursue claims against some or all of the remaining defendants, including PwC.

*AIG, the largest U.S. insurer, on Friday restated its claims against Greenberg and Smith for allegedly breaching the fiduciary duties they owed the company, while shareholders refiled their claims against some of the original defendants. AIG "decided not to sue (PwC) based on the recommendation of a special litigation committee of AIG's board of directors" and **the company "continues to have full confidence in the independence of PwC,"** a company spokesman said...*

Arthur Levitt and AIG – Gone Over To The Dark Side, Artie?

Oct 24th, 2007



AIG has reappointed of PricewaterhouseCoopers as their external auditor. I am incredulous. I was slightly apoplectic too, but then I calmed down.

After all, greater minds than mine, like the famous Arthur Levitt, have made sure that, ***“AIG’s selection process was designed and executed with integrity, and the Audit Committee’s evaluation of the proposals was both fair and impartial. AIG did an exceptional job.”***

It seems Levitt was hired by AIG in 2005 to spruce up their image in the wake of Elliott Spitzer’s investigation of AIG. Mr. Levitt’s tenure at that time was expected to be less than a year as a special consultant to the Board, but it has obviously taken longer than that to address AIG’s governance problems and will continue to take longer to fix them completely, if that’s possible. Mr. Spitzer was the former Attorney General for the State of New York and is now their Governor.

The audit committee of AIG’s board of directors spent 12 months on the RFP process, which is part of the company’s 2006 settlement with the New York Attorney General’s Office, said AIG spokesman Chris Winans.

The agreement, Winans said, required AIG to take actions above and beyond the normal annual review of its relationship with the company's independent auditor. This RFP is something we did as part of the settlement agreement, he said. It requires us to do the RFP process for the 2008 fiscal year.

In 2006, AIG agreed to pay a total of \$1.64 billion to settle litigation stemming from New York state and federal investigations of its accounting, financial reporting and insurance brokerage practices, and claims related to workers' compensation premium taxes.

Mr. Levitt, therefore, is not a court appointed monitor based on a settlement with the SEC, a la [Mr. Breeden and KPMG](#), but a shill for AIG.

Interestingly enough [Mr. Levitt has a long and contentious history with PwC](#). It all goes back to reforms he wanted to make to how the audit firms did and didn't do business and how PwC was the big stubborn holdout. This was in spite of the fact that [they had been nabbed big time with serious independence violations](#) and the SEC could have disqualified the audited financial statements of all of their clients (and caused them to have to resign from those clients) if they had not cooperated with the regulators at the time. For a history of this sword fight, go [here](#).

So it's all the more surprising that Arthur Levitt was willing to stand by and put his imprimatur on the charade which is the reappointment of PwC at AIG. After all, [AIG's shareholders are suing PwC](#). And [PwC has been AIG's auditor for as long as they have been in trouble](#).

I have seen some Google searches regarding this “RFP” process wherein other firms, in particular Deloitte, are searching for more details about why they weren’t chosen. Let me give them all a clue... The fix was in.

I have requested via the Freedom of Information Act provisions for the State of New York Attorney Generals office, a copy of the RFP, the responses, the evaluation process and the grading of all proposal submissions. I have heard no response from them. Given that this was a public agency mandated process, I would assume that public disclosure would be mandated. Will make for interesting reading, if so. How can anyone for the Attorney General’s Office be sure that it was a fair and competitive process if they also do not see and approve the process that AIG conducted?

As for Mr. Levitt, I am disappointed. I guess everyone has to make a buck. But I had hoped he would do it by being on the side of the investor and the other stakeholders of AIG, and not on the side of perpetuating the myth of a job well done by PwC as AIG’s auditor.

Update: One of [my favorite writers](#) on these subjects reminded me: *“If you really want to have some fun with this, remember also that Levitt can’t let go of his affiliations inside the Beltway — now acting as co-chair of the so-called Paulson committee, along with [Don Nicholaisen](#). Looking at [the list of members](#), it’s almost sure to be MOTS...”*

Is Goldman Dumping PwC?

Dec 28th, 2007



Over the river and through the woods, news traveled to me of the potential for Goldman Sachs to dump PwC as their auditor or at least take away a large portion of their humongous fees and give them to Deloitte.

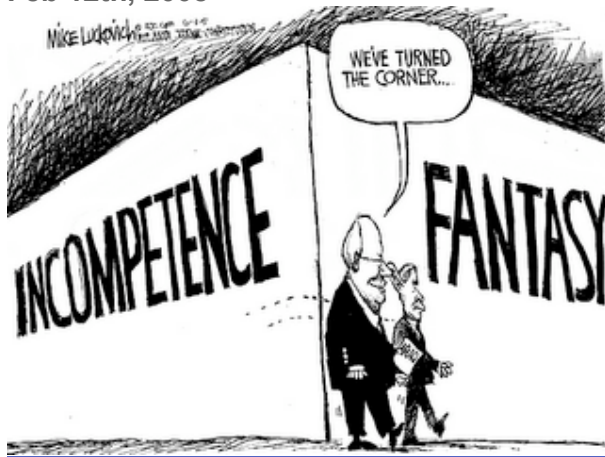
Why? Is it because Goldman is much closer politically to Deloitte? Maybe their friends in high places told them to send the business to Deloitte.

Who's pulling the strings? Paulson? Thain? Levitt through the back door?

Inquiring minds want to know. I hope it's nothing I've said...

[The PwC – AIG Clusterschmuck](#)

Feb 12th, 2008



[Image Source](#)

See my previous comments on this unholy alliance [here](#), [here](#), [here](#), [here](#) and [here](#).

See my comments in the NYT on this article [here](#).

How Bad Is It? AIG Can't Tell

If someone wants to buy insurance against a risk, perhaps the insurance company should assume the risk is real.

*American International Group shares are down sharply today, after the insurance company said **its auditors at PricewaterhouseCoopers had concluded that it had a material weakness in its internal controls related to its estimate of the value of its credit default swap portfolio.** It can't quite figure out how big a writeoff to take in the fourth quarter, but it is going to be big.*

A.I.G.'s explanation of all this is in an [S.E.C. filing](#) today. If you can understand the details of what they are saying, congratulations. I can't.

But what it boils down to is this: A big, supposedly sophisticated insurance company took risks it did not completely understand, and now is scrambling...

My comments in the New York Times article by Floyd Norris mentioned above:

2. February 11, 2008 2:46 pm
[Link](#)
- Sorry to say I'm not surprised. PwC and AIG are an unholy alliance. I've written about this mutually self-serving relationship extensively at <http://Retheauditors.blogspot.com>

— *Francine McKenna*

8. February 11, 2008 6:04 pm
[Link](#)
- Eggolas,
- What that last sentence means is that PwC and AIG disagree on what type of controls must be in place to appropriately determine fair value of these instruments. PwC says that a stronger set of controls need to be in place in order to provide appropriate internal control and AIG says that they have different controls (maybe manual versus automated controls) that compensate for the fact that they don't have the ones PwC insists on and that in AIG's eyes mitigate the risk of an inaccurate valuation sufficiently. When is PwC going to resign from this client? It's way, way, way overdue.
- fm
<http://Retheauditors.blogspot.com>

— *Francine McKenna*

PwC Tough On AIG? Too Little Too Late

Feb 29th, 2008

When will the class action lawyers force AIG to fire PwC?

AIG's acknowledgment of their exposure to writedowns in their derivatives portfolio came soon after their December disclosures that underestimated the losses. PwC, with their long, long relationship to AIG and the recent renewal of the relationship with the blessing of Levitt, are not so much tough as "scared witless."

Derivatives are bothersome fellows, especially in a crazy market. There's another client holding on to their longstanding auditor even though they can't get the derivatives story straight either.

Do the Big 4 really have the expertise to judge their clients on this issue?

Insurance giant American International Group(AIG – Cramer's Take – Stockpickr) said late Thursday it swung to a \$5.3 billion loss in the fourth quarter thanks to \$11.5 billion in writedowns on derivatives.

The company logged a net loss of \$5.29 billion, or \$2.08 a share, for the quarter, compared with earnings of \$3.44 billion, or \$1.31 a share, for the year-ago period. Excluding special items, AIG said it lost \$3.20 billion, or \$1.25 a share, compared with last year's earnings of \$3.85 billion, or \$1.47 a share.

Analysts on Wall Street were expecting earnings for the quarter of 60 cents a share, according to consensus estimates reported by Thomson Financial.

The company said its results included a writedown of \$11.47 billion on mark-to-market losses in its super senior credit default swap portfolio. Earlier this month, AIG [disclosed](#) in a regulatory filing that its auditor, PricewaterhouseCoopers, concluded it had “a material weakness in its internal control” related to its [accounting](#) for that portfolio.

That stood out in stark contrast to the company’s assurances in December that it had “little to no exposure” to asset-backed commercial paper, structured investment vehicles or collateralized debt obligations tied to residential mortgage-backed securities. It reported a \$4.88 billion writedown in gross market value for its [credit](#) default swap portfolio in October and November — more than four times the \$1.15 billion executives reported earlier.

PwC and AIG – Beyond Ludicrous

May 9th, 2008



Picture Source

Why was PwC given the job again when they've clearly not been doing their job?

Why does the SEC and PCAOB allow the comedy of errors and contradictions that is an adverse opinion on internal controls and a clean opinion on the financial statements? Especially now that the audit and opinion are supposed to be integrated?

I asked Christopher Cox and he gave a non-answer.

Why is PwC still the auditor of this mess of a client? What's in it for them?

Oh, I forgot. \$45 million in fees. Sure must be giving some partner over there a headache. I hope his wife has adequate life insurance because he's headed for a heart attack or worse...

Why is everyone [allowing AIG to help PwC by saying they were duped](#)? When does this become a non-excuse? If there's lack of proper tone at the top, isn't this the reason an audit firm does everything in its power to protect itself, including resigning?

I'm incredulous.

[Pricewaterhouse's Squeeze Play
AIG Says It Misled Auditor, As Greenberg Cites Review
Clearing Internal Controls](#)

American International Group Inc.'s lengthened laundry list of accounting woes shines the spotlight more brightly on the role played by its outside auditor, PricewaterhouseCoopers LLP.

In an unusual admission of accounting impropriety, AIG disclosed late Sunday that accounting problems are likely to cut its net worth 3.3%, or by \$2.7 billion, considerably more than the \$1.77 billion estimate of a month ago. The new figure came as AIG said it would postpone filing its annual financial statement with the Securities and Exchange Commission, already delayed twice, until as late as the end of this month. The increase stems largely from a slew of improper accounting practices identified during the past month as its internal probe continued. The company also faces investigations into its accounting by state and federal authorities.

The insurer's latest release offered some relief for the accounting firm: It noted that "in certain instances," improperly booked transactions "may also have involved misrepresentations to management, regulators and AIG's independent auditors."

Specifically, the company said Pricewaterhouse wasn't told in full about AIG's ties to or dealings with two offshore reinsurance companies that AIG, because of the internal reviews, now plans to consolidate into its financial statements. That change alone could account for most of the \$1.2 billion hit to AIG's book value from "risk-transfer matters."

*Still, "at a certain point, **if auditors can only find out about [improper accounting] if management tells them about it, then what do we have auditors for?**" said Lynn E. Turner, a former SEC chief accountant and managing director of research for proxy-advisory concern Glass Lewis & Co. "The reason we have auditors is to give investors confidence that an outside third party has looked at them and found things that might turn out to be big errors."*

*...AIG also acknowledged that **former executives at times had been able to "circumvent internal controls over financial reporting."** As a result, AIG said Pricewaterhouse likely will fault the insurer's internal financial controls in the annual report to come even as it is likely to give the insurer "unqualified" opinions on its financial statements as well as its assessment of its internal controls. AIG said its shortcomings constitute "material weaknesses" under regulatory guidelines. Internal controls are processes to ensure accurate financial reporting.*

AIG said one reason its internal controls didn't pass muster was the ability of "senior management" to get around the safeguards. AIG said it is has begun strengthening the controls.

In a statement, David Boies, an attorney for former AIG Chairman and Chief Executive Maurice R. "Hank" Greenberg,

said a finding of weak internal controls would be “inconsistent with the conclusions” of Pricewaterhouse and AIG’s audit committee “after extensive review.” A spokesman for Mr. Greenberg’s lawyers said that, in a report to AIG’s audit committee on March 7, after 50,000 hours of work auditing AIG’s internal controls, Pricewaterhouse at that point “was unambiguous as to its finding that there were no material control deficiencies.” Mr. Greenberg was pushed out in March amid the mounting scrutiny.

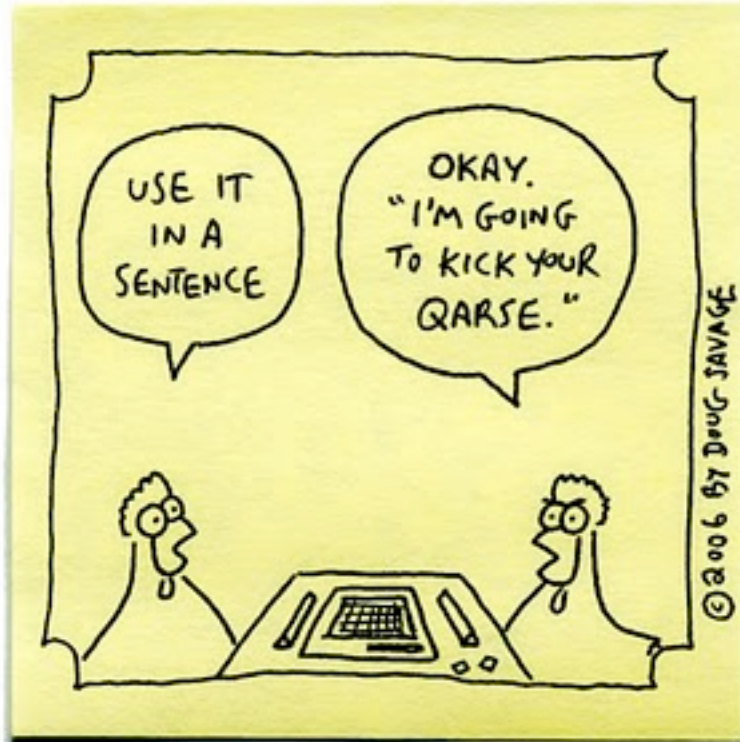
Presidential Endorsements, Politics, and Arthur Levitt

May 19th, 2008

Category: [AIG](#), [PricewaterhouseCoopers](#)

Savage Chickens

by Doug Savage



www.savagechickens.com

[J. Robert Brown](#) over at Race To The Bottom is always good for thought-provoking insightful posts. That is if you like that sort of thing rather than short, tongue-in-cheek, throwaways.

Which I do.

So I have to have a ["Black Eye"](#) not a ["Red Eye"](#) before I sit down to see if he's written anything new and interesting. After perusing the latest on Saturday morning, I've now got a full pipeline of new legal-type stuff to comment on.

Some of you may have started to think, “*Why does an accountant who purports to write about the Big 4 write about lawyers so much?*”

Well, by the looks of some of the incoherent searches I’ve seen leading to my posts, some of you may never use the word “purport.”

But I digress. I mean, I’m getting off the subject. “Digress” is another word some you may never use.

Lawyers use words, not numbers, to misdirect, mislead, and misbehave. That’s why I like them.

I’m a word person. Scrabble is my game, in English and in Spanish. In fact, I like to play it in Spanish with the Mexican waiters at a local wine bar just to push myself. Now that’s an intellectual challenge.... Scrabble in Spanish, after a few glasses of Brunello di Montalcino...

There I go again.

What was I writing about?

Oh, yeah.

Arthur Levitt.

So, J. Robert Brown tells us that three former SEC Chairmen have endorsed Barack Obama for US President.

Oh, so refreshing. As J. Rob tells us:

SEC Chairmen and the Presidential Election

The WSJ reported yesterday that three former Chairmen of the SEC (Ruder, Donaldson, and Levitt) have endorsed Barack Obama. In other words, they are not endorsing John McCain.

*... Whatever the polls say about the close nature of the election (McCain and Obama are running almost even), this type of endorsement does not bode well for the McCain campaign. It suggests that **those connected to business interests (Chairman Levitt has a long history on Wall Street, including running the American Stock Exchange, Chairman Donaldson ran the NYSE) are gravitating towards Obama.***

*Chairman Levitt, by the way, was in Denver last week for the Rocky Mountain Securities Conference. **He, as usual, gave opinionated and blunt remarks** that demonstrate his continued belief in the mission of the SEC...*

Ya gotta love Arthur Levitt. He's a pistol.

So, I ask Mr. Levitt:

If you're really on the side of bright new things and change and right, why are you [still shilling for AIG and PwC?](#)

Arthur Levitt – Looking Down From The Mountain

Jun 9th, 2008

Category: [AIG](#), [Audit Quality](#), [PricewaterhouseCoopers](#), [SEC](#), [Sarbanes-Oxley](#), [Subprime](#)



[Arthur Levitt](#) recently gave an interview in a Dutch publication *de Accountant*. [Accountancy Age](#) in the UK highlights some key quotes and provides a link to the full article in English.

Levitt comments about the potential need for “audit-only” firms and his encouragement of, “...*greater transparency, to understand what condition a firm is in. We need **the firms to provide fully documented audits of their own operation...***”

This [information is already available in the PCAOB’s inspection reports of the firms](#). However, per statute, the PCAOB does not have to make this information public unless the firm is seriously deficient in responding to any items cited. Given the delays on getting inspection reports completed, distributed, responded to, and finalized, it’s a wonder anyone fixes anything on a timely basis. *Just let it spin through the cycle* was the motto of one firm’s Risk and Quality guys when I was around that stuff...

And then there's the common practice for the firms to tell the PCAOB, "*Thanks for the info. But, we disagree.*"

So [Mr. Levitt's](#) contention that more transparency regarding how well firms are run is coming is just a bunch of hot air. The firms will not divulge this info voluntarily and the PCAOB does not have to per law. Like we're going to get that kind of change to the Sarbanes-Oxley law... It will be a cold day in *H*E* double-toothpicks*.

It's worth reading the whole article, since there are some other interesting observations thrown in.

However, this one in particular caught my eye:

As to the effects of the present credit crisis: have we had the worst?

*"No, I think it will continue for a while. Real estate values will continue to decline. I think we will see some bank problems, clearly **more corporate problems similar to AIG.**"*

Wow!

Levitt mentions AIG in a discussion of the general impact of the credit crisis?

If he feels so strongly, why doesn't he get on the side of right and help get rid of [the auditor who allowed the problems to occur](#), instead of [rubber stamping their reappointment?](#)

To back up further the case for firing PwC, we've now got the most recent news that the [Department of Justice has asked the SEC to turn](#)

over evidence as part of a criminal investigation of whether the material weaknesses in internal control cited by PwC in February were part of a fraud, one that their auditors didn't "detect" until the subprime crisis heat was on. Maybe Mr. Levitt should focus on the most obvious conflicts in his own backyard – the fact that PwC is being sued by its own client for its part in AIG's repeated failures.

Maybe the shortsightedness has to do with Mr. Levitt's own myopia regarding one of the most basic conflicts in the world – he's being paid by AIG and so is PwC.

[AIG CEO To Step Down](#)

Jun 16th, 2008



Now, please tell me [PwC is next](#). It would be a breath of fresh air all the way around. Why wouldn't PwC want to [draw a bright line](#) under their potential liability for [this mess](#)?

(At least [one article mentions PwC](#), but PwC doesn't comment, as usual.)

[AIG Chief Expected to Step Down](#)

The board of American International Group Inc. is meeting today to accept the possible resignation of Chief Executive Martin Sullivan, according to a person familiar with the matter...

*A decision to replace Mr. Sullivan, a 53-year-old AIG veteran who has worked at the company since he was 17, would underscore **the seriousness of the problems facing the global insurance giant**. Mr. Sullivan got the job when Maurice R. "Hank" Greenberg ended his nearly four-decade tenure atop AIG by stepping down in 2005 as **the company was under investigation for its accounting**.*

*At the heart of AIG's current problems are the **record-setting, multi-billion losses AIG has recorded in the last two quarters, and the severe drop in the company's stock price, which has fallen by more than half since early October...***

*It's not clear what a new chief executive, interim or permanent, can do to solve those problems amid ongoing upheaval in the mortgage and credit markets. **No new CEO can cure what ails American real estate.***

*Most of AIG's losses are driven by **write-downs tied to subprime mortgages**, and it could be some time before the company finds out what its losses ultimately will be. Until then, **the uncertainty, and the prospect of more write-downs, may frighten off some investors...***

*And a new leader who isn't closely tied to the Greenberg era could also have room to maneuver. Even as **Mr. Sullivan tried to steer AIG past the accounting scandal**, he had to contend with the fact that Mr. Greenberg – his onetime mentor – leads another firm, Starr International Co., that is **AIG's largest shareholder...***

Internal Auditors – Ignore At Your Risk

Oct 29th, 2008

I had a great conversation with the public relations manager at the [Institute of Internal Auditors](#) (IIA) the other day. As much as I have been involved in the past with this organization and as much as I have reached out in the past and offered to speak, write, teach, consult...

Well, it's not until they need you that you get the call.

Oh well.

Don't spit in the air, fm.

It seems the IIA is planning a big media push to highlight the role and importance of internal audit in identifying, monitoring, and recommending solutions for issues that the largest financial institutions have faced during the last several months. We now have "1929 conditions," as Forbes' richest man [Carlos Slim](#) was quoted as saying by CNBC this afternoon.

The IIA representative found my blog recently while searching for current, active blogs about internal audit. There are very few. He thought I might be able to come up with some examples in the current financial crisis where Internal Audit played a role or sounded an alarm that had been ignored.

That was easy. There are two very prominent recent examples: [AIG](#) and [Société Générale](#).

In the case of AIG, according to testimony given to Congress, [an internal auditor questioned Joseph Cassano](#), the head of AIG's credit default swap insurance business in London. Cassano allegedly told

the AIG internal auditor, who questioned why he was being excluded from valuation meetings:

“...you would pollute the process.”

According to the [Wall Street Journal](#), the internal auditor..

“...Mr. St. Denis said he resigned on Oct. 1, 2007, and that later that month, AIG’s chief auditor, Michael Roemer, asked him why and said he would report those reasons to AIG’s audit committee. Mr. St. Denis wrote that he told Mr. Roemer about Mr. Cassano’s comment. That would indicate that a key AIG executive last fall was aware of Mr. St. Denis’s concerns....”

[I’ve written before](#) about the difficulties Chief Internal Audit Executives have in being independent, objective, strong, do-or-die guys in the modern global public corporation. [Audit Committees that are not truly independent of management](#) and basic survival instincts/self-interest keep a lot of Chief Audit Executives from being either heroes or scapegoats.

They just are. There. Going along. Getting along. (It’s even worse when your internal audit function is outsourced to the Big 4. Management is paying them to be “on the team.” If they cross the wrong guy, they lose the client and, worse case scenario, may get sued.)

In the case of Société Générale, I’ve written extensively about the elaborate risk management, internal audit, and compliance policies and procedures in place at this bank before the “rogue trader” scandal.

From [my very first post on the scandal](#) in January 2008:

The [Société Générale 2006 Annual Report](#) devotes quite a few pages to the subjects of risk management and controls.

First, they discuss the elaborate internal control organizational structure and its interaction with the Audit Committee. **Pages 89-95 describe the internal control organization and how the internal audit function carries out inspections.**

On page 99, we see the report on internal controls prepared and signed by the dual auditors under French law who review Société Générale's books and records and have provided a clean opinion, agreeing with management's assessment of internal controls. There were no exceptions cited. Société Générale has the benefit of both Ernst and Young and Deloitte to assist them in making sure everything is in order and functioning to produce financial information that is valid, true and complete.

There's an entire chapter, pages 127-150, of the annual report devoted to Risk Management. This section covers all the risks they face and the myriad of policies, procedures, organizations and systems they, theoretically, have in place to manage them.

So what happened?

I think we can safely say that this facade of a strong risk management, compliance, and internal audit infrastructure at Société Générale was, how shall we say, *une façade, une illusion, un faux visage?*

Arthur Levitt Should Just Shut Up About AIG

Mar 25th, 2009

This should be read alongside yesterday's story on [Lynn Turner](#). If Levitt and Turner sell out the shareholder and the ideals of the accounting profession in all of the mess of the financial crisis, who's left?

The esteemed Arthur Levitt Jr. was the longest tenured SEC Chairman (1993-2001). He's an adviser to the [Carlyle Group](#), board member of [Bloomberg LP](#), and a board member of [RiskMetrics Group](#), a public company that serves 70 of the 100 largest investment managers, 34 of the 50 largest mutual fund companies, 41 of the 50 largest hedge funds and each of the 10 largest global investment banks.

Bloomberg LP journalists have quoted Mr. Levitt constantly during the last six months. He's featured on Bloomberg TV, in on line podcasts, and in print in almost every article about Madoff, the financial crisis, and mark-to-market accounting. And now he's used as an expert on AIG and incentive compensation.

That's for sure.

Arthur Levitt Calls AIG Bonus Tax `Extreme'

March 20th Bloomberg Surveillance

Arthur Levitt talks with Bloomberg's Tom Keene and Ken Prewitt about the U.S. government's proposed taxes of the bonuses American International Group Inc.

Re: the AIG Bonus Issue *March 17th, Bloomberg "If these were contracts drawn with employees, no matter how*

unreasonable they may seem, those contracts should be honored, in my opinion.”

Indeed.

However, I didn't think Levitt came off so well when he was interviewed recently in the New York Times Magazine “Questions For...” column by [Deborah Solomon](#).

[Money Manager](#) Interview by Deborah Solomon January 22, 2009 Excerpt:

Solomon: *Frankly, I can't understand why the S.E.C. culls its leaders from the world of high-stakes investment. What about what economists call the “capture theory,” whereby regulators become co-opted by the industries they regulate?*

Levitt: *The 4,100 people who worked for me at the S.E.C. were as patriotic as anyone I served with in the U.S. Air Force or the several government commissions I've served on, and I've worked for four presidents.* **Solomon:** *That's just boosterism. You're not answering the question.*

Levitt: *The European system of gray bureaucrats running government agencies forever is far less effective than the refreshing American system of re-potting private-sector talent to bring in new ideas.*

It wasn't the image of populist, investor protection Viking he had worked so hard to cultivate over the years. It may be hard to remember that much of that reputation was well deserved.

Back in June of 2002, a Frontline segment entitled [“Bigger Than Enron”](#) described the battles Levitt had with the accounting industry, and in particular Price Waterhouse (legacy

firm of today's PwC), over changes in rules about auditor independence that he supported.

Frontline: *What kind of clout does the accounting industry have on Capitol Hill?*

Levitt: *I guess I learned over coming months that they had enormous clout; that their contributions to members of Congress who never thought about an accounting issue or an accountant and suddenly picked up the cudgels for the profession; where my own congressman was led into the belief that this was an effort that might have been worthwhile and signed on to a letter which he later retracted on the floor of the Congress; where a close friend of mine who I'd climbed eight mountains in Colorado with while he was head of the Outward Bound School signed on to another letter that he later retracted on the floor of the Congress.*

This was a broad-ranging campaign that was well-financed, well-structured, and extremely vigorously fought.

Frontline: *Well, speaking of letters, I have a letter that you got in April. What is this letter?*

Levitt: *This is a letter from the overseers of the SEC, the congressional committee that oversees the SEC that has a choke hold on the existence of the SEC, that can block SEC funding, that can block SEC rule making, that can create a constant pressure in terms of hearings and challenges and public statements, that can absolutely make life miserable for the commission.*

And here the three leaders, Tom Bliley, the chairman, Mike Oxley, the head of the subcommittee, and Billy Tauzin, the

chairman of another subcommittee, were directing me to go slow on this issue, to go through a process...

The legislation that Levitt was pursuing to prohibit auditors from also acting as consultants for their audit clients was eventually incorporated in the Sarbanes-Oxley legislation of 2002.

In May of 2008, Tom Nierop, chief editor of *de Accountant*, [interviewed Levitt](#) in New York. This Dutch publication focuses on the accounting industry and the interview was mostly about the future of the accounting firms. However, Levitt made some additional comments about the subprime crisis and AIG. His mention of AIG by name at that particular time is quite surprising, given that he had been recently under contract to AIG to help them become a better governed, more transparent company.

Nierop: *This influence [they were speaking of the influence of activist investor coalitions] is already visible in the discussion on compensation and bonuses for top management.*

Levitt: *“The only way I can think of to address those issues is public embarrassment. The media is quite important there. And the strengthening of independent boards, compensation committees, and organizations like ISS, of which I am a director. [ISS was acquired by RiskMetrics where Levitt is a board member.] And there are other organizations that will have an affirmative impact. It is not something you simply can address by a rule.”*

Nierop: *Why is an extra financial incentive, next to regular compensation, necessary at this level of management?*

Levitt: “Because a board is fraternal board rather than a skeptical board. Compensation committees lack the backbone to do something about it. But the boards are becoming more skeptical because they don’t want to see their names in the papers.

Nierop: Can we really avoid a next financial crisis without fundamentally assuring some sort of ‘ownership at the top’ for the proper systemic functioning of the markets?

Levitt: “The lines of responsibility should be more clearly defined. I don’t believe in principles based regulation, I believe in enforcement based regulation. Except as to when it deals with systemic risk. Systemic risk is so evasive that I think you need the flexibility of some sort of prudential oversight. But certainly not with respect to certain kinds of market structures.

And what role a central banker should play in this, remains to be seen. Their failure has been profound. Every step of the way. Yet if they are providing the money to bail out investment banks, they clearly have to have had some responsibility in overseeing them.”

Nierop: As to the effects of the present credit crisis: have we had the worst?

Levitt: “No, I think it will continue for a while. Real estate values will continue to decline. I think we will see some bank problems, clearly more corporate problems similar to AIG.”

Why did Levitt go to work for AIG again in 2007 after his [stint there in 2005](#)? Why did he help paper over their decision at the end of 2007 to re-appoint PricewaterhouseCoopers as their auditor, even after all of the messes [PwC has presided](#)

over, been sued over and settled over, looked the other way on,
and acted on only when forced by threat of more litigation?

Arthur Levitt and his AIG auditor selection committee didn't fire incorrigible but complicit PwC at the end of 2007. They reappointed them so PwC could stay close and no other firm get closer once the investigations for 2007 activities started. It wasn't long before the Department of Justice asked the SEC to turn over evidence as part of a criminal investigation of whether the material weaknesses in internal control cited by PwC in February 2008 were part of a fraud, one that their auditors didn't "detect" until the subprime crisis heat was on.

PricewaterhouseCoopers earned over \$120 million dollars as AIG's auditor and tax advisor in 2007. Why is there no outrage by Mr. Levitt and the press over that outrageous waste of shareholders money? How could Matt Taibbi write an eight page article in Rolling Stone magazine this past week detailing the history of AIG's issues and never once mention their external auditor, PricewaterhouseCoopers, by name?

Is it because PwC is impotent and potentially complicit in this situation, neither identifying the problems at AIG and warning shareholders and investors of them strongly enough, nor acting to mitigate them soon enough? At least the shareholders are trying to sue them. But why doesn't the AIG Board of Directors support the shareholders?

The Chairman of the Audit Committee of AIG's Board of Directors, the committee that manages the company's relationship with the external auditors, and their designated "financial expert," is one of Mr. Levitt's protégés during his years at the SEC, Michael Sutton. Sutton is a former Deloitte

senior partner prior to his time as Chief Accountant at the SEC under Levitt. Even though he's not a PwC alumni, we all know how those [Big 4 guys stick together](#). What is it about PwC that has seduced Levitt and Sutton and the rest? Is it that it's better to keep those who know where the bodies are buried on the inside, with as much to lose by having the worst of it come out as anyone else?

Well, we know why PwC stays in this abusive relationship. There are more than \$120 million reasons.

But why is Mr. Levitt is still defending AIG and, therefore, PwC?

Remember, Mr. Levitt is the guy who said, *"the only way I can think of to address those issues [i.e. executive compensation excesses] is public embarrassment."* Why isn't Mr. Levitt embarrassed that he was paid by AIG to improve their corporate governance and transparency to regulators and [one of the worst corporate governance failures imaginable is the result?](#)

Can Levitt still believe, as [he told the International Herald Tribune](#) barely a year ago, *"They took just about every recommendation I made," says Arthur Levitt Jr., a former Securities and Exchange Commission chairman who began advising AIG's board after it ousted Greenberg. "In terms of process and governance, now it is about as good as a board can get."*

Maybe it's time to put a sock in it, Mr. Levitt.

[Damn The Conflicts: Arthur Levitt Still Won't Shut Up](#)

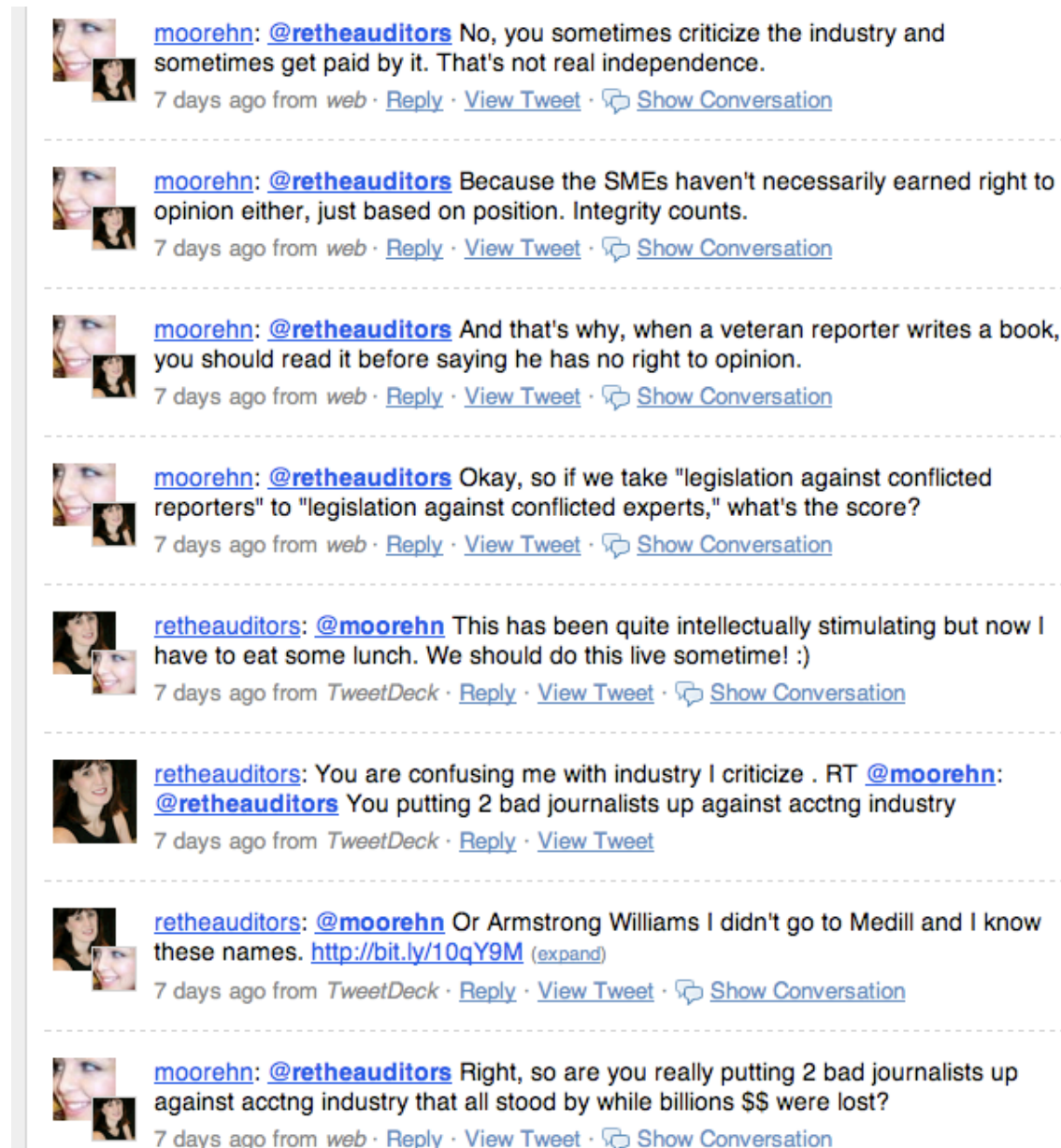
Aug 22nd, 2009

[The piece](#) reprinted below was posted back in March, 2009. I've put it up here again because of [the heightened interest in Mr. Levitt](#). He wrote a [recent Op-Ed piece](#) for the New York Times defending "high frequency trading." As you can see, the conflicts for Mr. Levitt, especially now that he is [also advising Goldman Sachs \(also a PwC client\)](#) and [Getco](#), are numerous.

Mr. Levitt is [78 years old](#). Isn't it time for him to go fishing? Why don't the numerous media outlets he works/writes for insist that he disclose his conflicts? The perception the rest of us have is that he's using the New York Times, Bloomberg, the Washington Post, the Wall Street Journal, and others in the interest of promoting his clients' interests. [Used to be](#) you could count on Mr. Levitt to be an advocate for the average investor. Now he's much more ["Zelig-like."](#) representing the interests of whichever client is paying for the podium he's constantly being given. Is he getting paid double – by his clients and those hiring him to write and commentate?

I had a [long, very winding, totally spontaneous conversation on Twitter](#) last Saturday the 15th with [Heidi Moore](#), the former Wall Street Journal and The Deal, now freelance, journalist. We were talking about journalists as subject matter experts and the difference between conflicts of interest for journalists versus bloggers. Heidi and I have very different perspectives on most of what we discussed – mostly because I am a subject matter expert who blogs and she is a freelance journalist who has developed subject matter expertise in the areas she has written

about most frequently. We were converging on some type middle ground of “journalistic” approach and ethical conduct but coming from two different directions and with 15 years of experience separating us.



The screenshot shows a series of tweets in a conversation. Each tweet includes a profile picture of the user, their name and handle, the text of the tweet, and interactive links for 'Reply', 'View Tweet', and 'Show Conversation'. The tweets are separated by horizontal dashed lines. The conversation starts with @moorehn replying to @retheauditors, followed by @retheauditors replying to @moorehn, and then @moorehn replying to @retheauditors again.

moorehn: @retheauditors No, you sometimes criticize the industry and sometimes get paid by it. That's not real independence.
7 days ago from *web* · [Reply](#) · [View Tweet](#) · [Show Conversation](#)

moorehn: @retheauditors Because the SMEs haven't necessarily earned right to opinion either, just based on position. Integrity counts.
7 days ago from *web* · [Reply](#) · [View Tweet](#) · [Show Conversation](#)

moorehn: @retheauditors And that's why, when a veteran reporter writes a book, you should read it before saying he has no right to opinion.
7 days ago from *web* · [Reply](#) · [View Tweet](#) · [Show Conversation](#)

moorehn: @retheauditors Okay, so if we take "legislation against conflicted reporters" to "legislation against conflicted experts," what's the score?
7 days ago from *web* · [Reply](#) · [View Tweet](#) · [Show Conversation](#)

retheauditors: @moorehn This has been quite intellectually stimulating but now I have to eat some lunch. We should do this live sometime! :)
7 days ago from *TweetDeck* · [Reply](#) · [View Tweet](#) · [Show Conversation](#)

retheauditors: You are confusing me with industry I criticize . RT **@moorehn: @retheauditors** You putting 2 bad journalists up against acctng industry
7 days ago from *TweetDeck* · [Reply](#) · [View Tweet](#)

retheauditors: @moorehn Or Armstrong Williams I didn't go to Medill and I know these names. <http://bit.ly/10qY9M> (expand)
7 days ago from *TweetDeck* · [Reply](#) · [View Tweet](#) · [Show Conversation](#)

moorehn: @retheauditors Right, so are you really putting 2 bad journalists up against acctng industry that all stood by while billions \$\$ were lost?
7 days ago from *web* · [Reply](#) · [View Tweet](#) · [Show Conversation](#)

Arthur Levitt is no journalist, no matter how many columns he writes, Op-Eds he pens, or business news shows he appears on. He is a subject matter expert, a lobbyist, being treated as if he has an independent, objective, sage-like opinion on

everything finance- and markets- related when he does not.
He makes money the old fashioned-way – clients pay him.

See March 25, 2009, [*“Arthur Levitt Should Just Shut Up About AIG”*](#):

They Weren't There: Auditors And The Financial Crisis

Dec 7th, 2009

“When the power brokers of the business world meet, the accountants are never far behind.

While other industries have downsized through the turmoil of the financial crisis, the “Big Four” accounting firms — PricewaterhouseCoopers, KPMG, Deloitte Touche Tohmatsu, and Ernst & Young — will end the year with more employees than before the crisis started. Despite a rocky decade that included the Enron scandal — whose accounting shenanigans also took down Arthur Andersen, then one of the world’s largest accounting firms — and the financial crisis, the accounting industry has emerged stronger than ever before.

“When I called the CEO of one of our very large clients in the U.S. — it would be inappropriate to tell you who — there was a time when you would call them and his secretary would say, ‘he’s very busy, he’s tied up in a meeting,’ ” said James Quigley, CEO of Deloitte. “What they say now is, ‘he’s on the plane right now — would you like me to patch you through?’”

[CNN’s Kevin Voigt](#) from the APEC Conference November 12, 2009

Oh really?

Fellow bloggers [Adrienne Gonzalez](#) and [Caleb Newquist](#) have already ripped up this CNN interview. We are all embarrassed for this journalist. He listened to a bunch of horse manure orchestrated by the audit firms’ public relations flacks and they published it with no verification, challenge, or context.

That's the other [“expectations gap”](#) we face as journalists when trying to add an independent, objective, and inevitably critical voice to the story of the accounting industry. If a journalist doesn't cover the audit firms and the business of accounting on a regular basis, they “expect” accounting industry stories to be boring and maybe a little tedious or hard to understand. They also “expect” it to be difficult to verify numbers, statistics, and trends about the revenues, profits, and headcounts of the largest audit firms. So... Maybe they take their word for it. After all, they're accountants. (It's sadly true that there's [a dearth of publicly available financial information](#) about the audit firms, especially in the US.)

But I was struck, actually flabbergasted, by the fat head remark above from Jim Quigley of Deloitte. He claims that big-time CEOs answer his phone calls these days. Exactly what is the CEO of Deloitte Touche Tohmatsu, Deloitte's global, non-auditing, [“coordinating” umbrella firm](#) doing calling CEOs about anything important nowadays? Seems like meddling to me. Deloitte, in particular, has [a lot fewer clients](#) to call these days anyway. Maybe instead of the CEO of the global firm calling, the [local partners should have shown some spine](#), such as with Bear Stearns and Washington Mutual?

I

've been writing about the subprime crisis, the one that morphed into the financial crisis, since 2007. My first post to mention *subprime* was March 14, 2007. In that post, discussing [KPMG and New Century](#), I talked about something that even the [esteemed short David Einhorn](#) missed: Repurchase risk was not being disclosed. I'm [still writing about repurchase risk](#) and the banks are still obfuscating it with the acquiescence of their auditors.

In one sense, the auditors **were there** all along. They've been riding sidesaddle, [cantering](#) obediently a few strides behind the [investment banks, mortgage originators, commercial banks, ratings agencies, and monoline insurers](#) who made the real estate bubble and, therefore, the

CDO/CDS/MBS bubble what it was. On the other hand, no matter how much I encouraged the auditors to step up, expected them to insert themselves, and hoped they would have an oversight impact, there clearly was no **“there”** there.

Some very smart men have told me... The auditors are irrelevant to this crisis. The financial crisis, unlike Enron or WorldCom, was not about accounting fraud. Everything does not revolve around the auditors. The auditors were marginalized or maybe just deemed useless. The auditors are not the villains here. The auditors play no role when the stakes are this high. A GAAP valuation is not a “real” valuation.

These wise men may think they're [talking me down](#).

But, in fact, they've bolstered my case.

What is my case? Why do I keep writing critically about the audit industry?

From my [“About”](#) page:

The Roman satirist Juvenal asked, “Sed, quis custodiet ipsos custodes?” But who guards the guardians?

Unprecedented changes in the accounting profession, and professional services in general, mean the current approach to safeguarding shareholder interests, as well as the other stakeholders of the modern publicly traded global enterprise, is no longer efficient nor effective.

I've been reading [Andrew Ross Sorkin's “Too Big To Fail.”](#)

I would think that somewhere in the 544 pages of engrossing detail that purports to be, “the inside story of how Wall Street and Washington fought to save the financial system and themselves...,” you might see the Big 4

audit firms mingling with the rest of the masters of the universe. You might see them mentioned in the index. You might read about their influence over asset valuations and “fair value” and “mark-to-market.” After all, this latest crisis put [accounting and GAAP on the front page](#) again, on the lips of CNBC commentators, on the desks of Congressmen and Senators who would have liked to forget [the last time accounting was at the center of a financial crisis](#).

But...no.

None of the audit firms, not even Mr. “CEOs take my calls” Jim Quigley, are mentioned in Sorkin’s cast of characters. Although I’ve found a few references to PricewaterhouseCoopers already in the first 200 pages, the audit firms are not listed in the index. The references to PwC, related to the AIG/Goldman Sachs counterparty collateral dispute that began in 2007, leave more questions unanswered than resolved.

I found these PwC references after tiring of the book’s storytelling style after fifty pages. It’s my cross to bear that not much of what is written about the crisis is new to me. I’ve been living with these issues for the last three years and I’ve probably read everything, especially that Mr. Sorkin and his colleagues at the New York Times have written, about any of the companies or personalities involved. And I really don’t give a flying tomato about Paulson and Fuld as people...

But, to paraphrase Andrew Ross Sorkin in [a video from BookTV on CSPAN November 2, 2009](#): *“A book that reads like a movie is a book that will be made into a movie.”*

So I smiled to myself with extreme satisfaction when Mr. Sorkin mentions PwC at 37.35 into the CSPAN video. It’s part of an answer to the following questions:

“Where was Goldman on the line? Was Goldman really at risk?”

In **“Too Big To Fail,”** Mr. Sorkin tells me, on page 160, something interesting I did not previously know. AIG had publicly disclosed the existence of a collateral dispute with Goldman Sachs over CDOs in November of 2007. What I did not know before is that it was AIG Chairman of the Board Bob Willumstad, according to Sorkin, not PwC, who originally raised red flags in January 2008 regarding the growth of the collateral gap. Willumstad called in PricewaterhouseCoopers to review the situation and,

“PwC eventually instructed AIG to revalue every one of the credit default swaps... and embarrassingly disclosed that it had found a “material weakness” in [AIG's] accounting methods.”

Most media gave PwC credit at the time for [“getting tough with AIG.”](#) I called the actions by PwC [“too little too late”](#) and a [clusterschmuck](#). Why was PwC still AIG’s auditor? Afterall, they were being [sued by AIG’s shareholders for a prior restatement](#). In the end, AIG “admitted” that their management may have held back or even lied to the auditors. [AIG had actually given PwC an out](#), I said, to keep them close in the event of litigation or worse. Some called my assessment harsh.

In retrospect...

A few pages later, on page 175, Sorkin describes a Goldman Sachs June 2008 board meeting where the issue of their collateral dispute with AIG boils over.

“In a videoconference presentation from New York, a PwC executive (PwC is Goldman Sach’s auditor, too) updates the board on its dispute with AIG over how it was valuing or in Wall Street parlance, “marking-to-market,” its portfolio. Goldman executives considered AIG was “marking to make-

believe” as Blankfein told the board...the afternoon session proceeded with upbraiding PricewaterhouseCoopers:

“How does it work inside PwC if you as a firm represent two institutions where you’re looking at exactly the same collateral and there’s a clear dispute in terms of valuation?”

How does it work, indeed. Jon Winkelreid, Goldman’s co-president, may or may not have received an answer that day. Sorkin does not report one. I have never heard one.

Actually, I reported rumors at the [end of 2007](#) that Goldman was looking to dump PwC, or at least maybe give away some of their fees to Deloitte. But

I guess they changed their minds.

And so when I ask, *“Where were the auditors?”* and decry the fact that *“they weren’t there,”* it’s not due to some unreasonable, unfair focus on the most milquetoast of potential culprits.

As my dad would say, *“I ~~represent~~ resemble that remark!”*

No.

I bang this drum because the auditors should have been there, as a last stop, where the buck should have stopped, as gatekeepers, watchdogs, advocates, and the last bastion of standards and expected values shareholders can look to.

But they weren’t.

I’ll wrap this up with an excerpt from a post I wrote on September 17, 2008.

Most of it is still true:

I have no news of an auditor assignment for the new Fannie Mae/Freddie Mac under conservatorship. It may be that the new Boards required to be formed by the Fed will dump Deloitte and PwC and hire EY, given the connection with one of the new non-Executive Chairmen, Laskawy, who is a retired head of EY.

I have heard no news of who will audit AIG, as it is now owned 80% by the Fed. Will the Fed allow PwC, so much a part of their problem and their problematic past to continue, or will they start fresh with someone else? We don't know. It was not on the list of big concerns for those making announcements, since PwC neither helped AIG avoid problems nor were they obviously instrumental in helping resolve them.

And Merrill will be audited by B of A's PwC instead of Deloitte, as the acquirer is usually the one dictating those terms, much like Bear Stearns is now also under the thumb of JPMChase's auditor PwC.

Lehman, a long time EY client, will have to say goodbye to their friends. I say friends because EY did Lehman no favors in letting them get away with so much for so long. With some of Lehman disappearing or being sold off in pieces and much of it going to Barclays, there are any number of firms (well, really only four, the Big 4) that will end up as auditors of these businesses.

If you're seeing a pattern here it's no coincidence. All of the Big 4 audit firms have been very much involved, complicit, aided and abetted and/or been AWOL when it comes to the problems these firms faced and will continue to face. The Big 4 audit firms neither helped them avoid these "crises," nor helped warn others of the severity of the issues in enough time.

We find out how bad things really are once a year, only when pushed, or as a result of a lawsuit. Or, in these cases, we found out only when the firms were pushed to the edge of the abyss.

I wonder if their audit partner was there with them, looking over the edge, and apologizing.

The Great American Financial Sandwich: AIG, PwC, and Goldman Sachs

Feb 2nd, 2010

It may have been the first time you had ever heard of AIG. As big as it is, it wasn't really a household name outside of the financial services world. And certainly, big as it is, the average businessperson probably could not describe everything they did and why.

The Wall Street Journal, September 16, 2008: The U.S. government seized control of American International Group Inc. — one of the world's biggest insurers — in an \$85 billion deal that signaled the intensity of its concerns about the danger a collapse could pose to the financial system.

The step marks a dramatic turnabout for the federal government, which had been strongly resisting overtures from AIG for an emergency loan or some intervention that would prevent the insurer from falling into bankruptcy. Just last weekend, the government essentially pulled the plug on Lehman Brothers Holdings Inc., allowing the big investment bank to go under instead of giving it financial support. This time, the government decided AIG truly was too big to fail.

The U.S. negotiators drove a hard bargain...

Can you fault the journalists for not having any idea how incomplete and relatively inaccurate so much of what was written in haste back then would turn out to be?

The Washington Post, January 26, 2010: The federal bailout of AIG, which grew to a more than \$180 billion commitment, has attracted controversy and hounded Paulson, Geithner and

other officials who helped orchestrate the troubled insurer's rescue in September 2008.

In hearings last week before Congress, Treasury Secretary Tim Geithner came under fire for the bailout, given his prior role as Chairman of the New York Federal Reserve Bank, the chief architect of the deal:

From The Guardian, January 27, 2010: The US treasury secretary [Timothy Geithner](#) was accused of incompetence, obfuscation and of making "lame excuses" during a furious hearing on Capitol Hill over the government's contentious [bailout of the sprawling insurer AIG.](#)

In an unusually ill-tempered confrontation, members of Congress from both parties rounded on Geithner over a decision to use taxpayers' money to pay out the full \$62bn (£38bn) owed by [AIG](#) to banks such as [Goldman Sachs](#), [Merrill Lynch](#), [Barclays](#) and RBS... The biggest counterparty receiving money from AIG was Goldman Sachs. Visibly rattled, Geithner was obliged to confirm to the committee that his chief of staff, Mark Patterson, is a former -Goldman Sachs banker, as is Geithner's predecessor at the treasury, Henry Paulson. But he angrily defended those involved..."

But if you've been reading my stories about AIG and their auditor PwC, you would have first heard about AIG in 2007. I start with their earlier accounting issues, restatements, investigations and lawsuits as a result of, let's call it, **Crisis One**, to differentiate it from **Crisis Two** – the \$180 billion bailout that became necessary, suddenly, unexpectedly, as a result of a confluence of unprecedented economic events and

that could not have been anticipated by anyone, anywhere, in any way shape of form...

Yeah, right. If you believe that, Joe Cassano's got [a great deal for you](#) on a piece of Maiden Lane III. Sounds quite green and leafy, no?

In [June of 2007](#), I told you about former AIG Chairman and founder Maurice Greenberg suing AIG and PwC as a result of a shareholders derivative suit against him. I said, "Isn't it time for PwC to resign as AIG auditor?"

In [August of 2007](#), Greenberg's firm C.V. Starr...

*"...which remains an AIG shareholder—alleges in its petition [to the SEC] that AIG's longtime independent auditor should be forced to resign because **an AIG special litigation committee earlier this year authorized shareholders to pursue a derivative action against PwC in Delaware Chancery Court.** "AIG's decision to have the derivative plaintiffs prosecute the claims against PwC on behalf of AIG instead of having AIG's own counsel prosecute the claims cannot eliminate the conflict that exists," the Starr petition says."*

In [October of 2007](#), I told you how PwC was sued by AIG shareholders who filed an amended complaint because when AIG management took over the shareholders derivative suit, stepping into their shoes, they did not comply with their wishes and [decided to not sue PwC](#).

"...filed in Delaware Chancery Court on Friday. AIG shareholders previously sued in 2004, naming former Chief Executive Maurice "Hank" Greenberg, former Chief Financial Officer Howard Smith, PwC and others as defendants. In the

amended complaint, filed on Friday, the shareholders seek damages from PwC and others...

In June, AIG took over the shareholders' lawsuit against Greenberg and Smith, becoming sole plaintiff in the case and leaving shareholders to decide whether to pursue claims against some or all of the remaining defendants, including PwC.

*AIG, the largest U.S. insurer, on Friday restated its claims against Greenberg and Smith for allegedly breaching the fiduciary duties they owed the company, while shareholders refiled their claims against some of the original defendants. AIG "decided not to sue (PwC) based on the recommendation of a special litigation committee of AIG's board of directors" and **the company "continues to have full confidence in the independence of PwC,"** a company spokesman said...*

Also in October 2007, in spite of their role as a defendant in lawsuits by AIG shareholders, in spite of their longstanding relationship with the firm that was now in so much trouble, [PwC was reappointed as AIG's auditor](#), with the [endorsement of Arthur Levitt](#). Levitt had been hired by AIG to restore good corporate governance to AIG.

[Bloomberg, October 11, 2007](#): *The company interviewed at least three others over the course of a year for the job, which starts 2008, said AIG spokesman **Chris Winans**.*

PricewaterhouseCoopers, AIG's auditor for more than two decades, had approved financial results from 2000 to 2005 that were restated amid Spitzer's probe, lowering earnings by \$3.4 billion. AIG investors sued the auditor in a Sept. 28 amended filing to recover losses from the settlement and restatement.

“Many companies involved with corporate scandals have changed their auditors to regain investor trust,” said [Lynn Turner](#), a former chief accountant at the U.S. Securities and Exchange Commission. ... “disappointed” AIG kept “the auditor who failed investors by giving a clean bill of health on misleading financial statements.”

PwC gets reappointed as auditors, so that a few months later, they can tell AIG [what a screw-up they've been](#). In my opinion, it's [too little too late](#). But what's really going on here?

Crisis One litigation is still very much alive. After PwC's material weakness determination in early 2008, for the 2007 financials, there was an attempt to amend the ongoing suits to include a CDO/CDS cause of action. Research to support this request showed that PwC had been dealing with [closely related accounting issues](#) as far back as 2002, centered mostly around [EITF 02-3 valuation issues](#). The research revealed deep, longstanding internal controls issues that were now becoming painfully apparent.

Between Crisis One and Crisis Two (i.e., the 2004 and prior accounting irregularities that ousted Maurice Greenberg, and then the 2007 AIGFP mess), the players on both the AIG management side, and the PwC engagement team side, were pretty much totally traded out.

On the PwC side, [Global Relationship Partner Barry Winograd and Engagement Partner Richard Mayock](#) stepped down after the 2004 audit year and [Tim Ryan](#) and Mike McColgan took over as Global Relationship Partner and Engagement Partner, respectively. The AIG *Expanded Scope Audit*, for 2004 and prior, was a Herculean effort for PwC, involving a tremendous

amount of interface with AIG's own internal review, the attorney investigations led by law firms Paul Weiss and Simpson Thacher, as well as ongoing regulatory inquiries.

PwC had to pull out all the stops to come up with enough staff to complete the task – this was Sarbanes-Oxley prime push period and resources were constrained and at a premium. Although [Greenberg loudly disagreed](#) at the time, sources tell me most of those who had been, and were then, key members of the engagement team, left the engagement. While the change-outs at the top were largely political, many of the changes down in the ranks were people who were completely burned out on AIG, and unwilling to continue on that engagement.

At AIG, those managers such as [Cassano](#) not affected by Crisis One head chopping, were still in place, and the derivatives business largely missed out on any magnifying glass treatment as a result of Crisis One. Based on documents obtained during discovery related to Crisis One, it was clear PwC the firm was really red faced that they'd "missed it." When the replacement audit team moved forward, and then the rumblings of the CDO/CDS mess started being heard, PwC press releases coming out in February 2008 gave the impression that the firm's leaders were not about to be caught asleep at the wheel again. They threw the "material weakness" flag quite quickly.

And then you read the [Washington Post article](#) about the now revealed 2007 internal AIG emails, and follow the timeline in 2007. In retrospect, it's easy to see that by summer 2007 AIG management had a pretty good idea its risk of drawdowns on the CDS's is way more likely than the *"less than remote"*

characterization in the footnote description of prior years' financial.

How much of that early realization got on the PwC new engagement team radar? How many other big things did they [miss or pretend not to see?](#)

An AIG presentation dated [Nov 2007](#) was still totally minimizing any prospective increase in risk.

It was during 2007 that AIG's conflicts with Goldman Sachs over collateral for the CDOs became heated. [I wrote in December](#), based on reports by [Andrew Ross Sorkin](#) in his book, *Too Big To Fail*:

AIG had publicly disclosed the existence of a collateral dispute with Goldman Sachs over CDOs in November of 2007... AIG Chairman of the Board Bob Willumstad, according to Sorkin, not PwC, originally raised red flags in January 2008 regarding the growth of the collateral gap. Willumstad called in PricewaterhouseCoopers to review the situation and,

"PwC eventually instructed AIG to revalue every one of the credit default swaps... and embarrassingly disclosed that it had found a "material weakness" in [AIG's] accounting methods."

...AIG "admitted" that their management may have held back or even lied to the auditors. [AIG had actually given PwC an out](#), I said, to keep them close in the event of litigation or worse...A few pages later, on page 175, Sorkin describes a Goldman Sachs June 2008 board meeting where the issue of their collateral dispute with AIG boils over.

“In a videoconference presentation from New York, a PwC executive (PwC is Goldman Sach’s auditor, too) updates the board on its dispute with AIG over how it was valuing or in Wall Street parlance, “marking-to-market,” its portfolio. Goldman executives considered AIG was “marking to make-believe” as Blankfein told the board...the afternoon session proceeded with upbraiding PricewaterhouseCoopers:

“How does it work inside PwC if you as a firm represent two institutions where you’re looking at exactly the same collateral and there’s a clear dispute in terms of valuation?”

How does it work, indeed. Jon Winkelreid, Goldman’s co-president, may or may not have received an answer that day. Sorkin does not report one. I have never heard one.

It must be tough to be PwC, wedged between two powerful, lucrative, and equally complex clients. The money they’re raking in provides some solace, I’m sure.

Reuters, July 1, 2009: *AIG paid PwC a total of \$131 million in audit and other fees in 2008 and \$119.5 million in 2007. “I want to know what these fees were paid for,” shareholder Kenneth Steiner of Great Neck, New York said. “Why didn’t anybody know what was going on? What were the accountants doing? Were they sleeping?”*

For Goldman Sachs, PwC provides not only audit, audit related, and tax advice, they also provide similar services to other entities managed by Goldman Sachs subsidiaries. For 2008, *those fees totaled \$99.9 million.*

<i>Audit fees</i>	<i>\$56.0 (2008)</i>	<i>\$49.2 (2007)</i>
<i>Audit-related fees (a)</i>	<i>4.1</i>	<i>3.0</i>
<i>Tax fees (b)</i>	<i>1.7</i>	<i>2.3</i>
<i>All other fees</i>		

PricewaterhouseCoopers LLP also provides audit and tax services to certain merchant banking, asset management and similar funds managed by our subsidiaries. Fees paid to PricewaterhouseCoopers LLP by these funds for these services were \$38.1 million in fiscal 2008 and \$29.5 million in fiscal 2007.

Regardless of the fact that PwC is making more money from AIG right now, both clients are critical and they're hanging on to both tightly. So it's not surprising, under those circumstances, that PwC tries to minimize conflict with either unless absolutely necessary. In fact, even though they may have been taken to the woodshed by both in the past, they've escaped any significant public criticism for staying quietly and peacefully in the middle, neutral like Switzerland, when it comes to the disputes and conspiracy theories about the relationship between the two firms and each with the NY Federal Reserve Bank.

It may be that PwC has learned to [play both clients like a fiddle](#) from professional dancing bears like [Arthur Levitt](#). As we discussed earlier, Levitt played a significant role in getting AIG past most of the New York Attorney General's scrutiny after their actions against AIG. Part of that healing process included reappointing PwC as auditor. But Arthur Levitt is also a [paid advisor to Goldman Sachs](#). The Wall Street Journal did not

mention his prominent role with AIG when they published a [fawning homage to Levitt from Lloyd Blankfein.](#)

And we're not often reminded post- ["Goldman Sachs making out like a bandit as a 100 cents on the dollar AIG counterparty"](#) of the strange choice of Ed Liddy as CEO of AIG to replace [Mr. Willumstad](#) of "make PwC revalue the CDO's and issue a material weakness in internal controls" fame.

[The Wall Street Journal, September 16, 2008:](#) *By tapping Mr. Liddy as AIG's next CEO, the government is turning to someone with deep experience in the insurance industry, having served as chief executive of Allstate from 1999 to 2006....Mr. Liddy also has experience pulling apart empires, having helped dismantle Sears, Roebuck & Co. (from which Allstate was spun off) in the 1990s. Before joining Sears, Mr. Liddy worked under Donald Rumsfeld at drug maker G.D. Searle & Co. Mr. Liddy is on the board at [Goldman Sachs Group](#), the investment bank that Mr. Paulson led before becoming Treasury Secretary.*

Maybe PwC didn't stand a snowball's chance in hell to be a truly independent, objective advocate for shareholders by forcing a true and fair presentation, in all material respects, of the financial position of either one of these companies and the results of their operations and their cash flows in conformity with accounting principles generally accepted in the United States of America. But is there a truly good excuse for PwC to not have been a preemptive strike force, a beacon, an early warning system for shareholders of the financial Armageddon we faced? They had longstanding, thorough, perfect knowledge of both sets of financial statements.

Add to this perfect knowledge the additional capital markets insight PwC has given their audit relationship with other large global financial institutions such as [JP Morgan, Bank of America, Freddie Mac, Fortis, Barclays, Northern Rock...](#)

Well, you get the idea.

Why didn't PwC speak up, act more strongly to match mismatched valuations between entities like AIG and Goldman Sachs, raise their hand and shout fire, or at least warn of suffocating black smoke obscuring woefully inadequate risk management and of pricing "models" strung together like so many holiday lights electrical cords, faulty wiring and all, ready to blow the circuits?

Was it the fees?

Well, there's certainly \$230 million plus reasons in 2008 to play nicey-nice between the two clients. But that explanation would be too simple.

["Yves" at NakedCapitalism.com described the syndrome well](#) when referring to the New York Federal Reserve and their lousy deal with AIG.

No matter which way you look at it, the picture that is emerging of the Federal Reserve, as revealed by the ongoing probes into its AIG bailout, is singularly unflattering.

The explanations for its actions can only support one of two interpretations: that the Fed was a chump, taken by the financiers, or a crony, and was fully aware that it was not just rescuing AIG, but doing so in an overly generous way so as to assist financial firms in a way it hoped would not be widely noticed or understood.

I wrote similarly about PwC with regard to the [Satyam fraud](#).

*The dilemma for the PwC Global senior leadership “crisis team” now in India is that the answer to the burning question, “**How could Price Waterhouse India let this happen at Satyam?**” has four possible answers:*

a) Price Waterhouse India audit technique and “quality” standards demonstrate the epitome of incompetence and professional negligence,

b) Price Waterhouse India partners colluded with Satyam management to commit the fraud,

c) Price Waterhouse India partners were “[duped](#),”

d) Some combination of all three.

None of the answers will win PricewaterhouseCoopers International Limited a prize.

For an example of incompetence, over and above that which PwC and their client have already admitted to, let’s talk about one element of PwC’s audit process at AIG.

From a source:

Staff Accounting Bulletin No. 99 talks about that elusive concept of “materiality.” In its guidelines, SAB 99 says an omission or misstatement of an item in a financial report is material “...if, in light of the surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.” i.e., qualitative materiality.

The element of auditor judgment and adequate subjective “professional skepticism” was lacking, and it allowed the frauds leading to the 1999-2004 restatements, as well as the head-in-the-sand failure to identify the impending catastrophe being created in AIG Financial Products with the CDS / subprime derivative products. Year after year, the applicable boilerplate footnote in the financials continued to characterize the risk of ANY claims on those products, for the Super Senior tranche AIG was insuring, as “less than remote.” Until, of course, it was too late.

In workpaper after workpaper, PwC whizzes past areas that subsequently became problematic, by relying on the failure of the item to reach the established level of QUANTITATIVE materiality alone, with inadequate subjective analysis of the qualitative.

It’s particularly ironic that, in the AIG/PwC assessment of “remediation” needs during the Restatement — which resulted in termination of a number of AIG execs, and demotion or reassignment of others away from responsibilities for financial reporting — Joseph Cassano at AIG FP was given a clean bill of health and allowed to continue unabated down the path toward disaster. If ever there was a time when “looking under every rock” for more rattlesnakes was called for, it was during the 2005 Restatement. The fact that PwC failed to get even a sniff of what was coming a couple of years later from AIG FP — even after deploying DA&I and dozens of extra auditors to handle the “Expanded Scope Audit” for 2004 — is very sobering, and brings into question (as you regularly do) why audits and investigations are even bothered with.

I don't think PwC is a complete dupe for AIG and Goldman Sachs any more than they were in the [Satyam fraud case in India](#). I heard [rumors in December 2007](#) that Goldman Sachs was thinking of dumping PwC. Who knew then how angry Goldman was at PwC for their client AIG's intransigence on the collateral call? But it all worked out, didn't it? I guess Goldman decided, "Keep your friends close....and your lackeys closer."

Hell, Goldman Sachs is citing PwC's audit of AIG when criticized as having been unfair and disingenuous in its dealings with AIG.

[Bloomberg, January 9, 2010: Hank Greenberg](#), former chief executive officer at [American International Group Inc.](#), said [Goldman Sachs Group Inc.](#) is responsible for the collapse of the insurer during the economic crisis, the Wall Street Journal reported... "Mr. Greenberg appears to base his views on news reports rather than facts," [Lucas van Praag](#), a Goldman spokesman, said in an e-mail to Bloomberg News. "It is interesting that he doesn't mention the devastating conclusions about AIG reached by the company's own auditors [PwC]."

I asked Mr. Praag about that comment. I was surprised and pleased at the mention of an auditor in this context.

Dear Mr. Van Praag,

I found it curious that you cited AIG's auditors, PwC, in response to criticism of Goldman Sach's role in the AIG failure. Yes, PwC had something to say, in my opinion too little too late, on AIG's weaknesses. But PwC is still AIG's auditor. And PwC is also Goldman Sach's longtime auditor.

Regards / fm

Dear Ms McKenna:

I was talking was about Mr Greenberg's criticism of Goldman Sachs in its relationship with AIG and making the point that his opinion seems to rely on hearsay (news reports) and not facts.

Further, his remarks about his former company appear to ignore the fact that, in Dec 2007, PwC, its independent auditors, found that AIG had "material weaknesses in its internal control over financial reporting and oversight relating to the fair valuation of the AIG FP super senior credit default swap portfolio." This seems to me to make Mr. Greenberg's comments about our valuation of instruments protected by AIG bizarre, to put it very mildly.

Regards / Lucas

PwC has been walking a tightrope between these two powerful clients for a while. But never doubt that they are, at the same time, always looking out for their own interests. Consider the [class action lawsuit against AIG, PwC and others brought by the Ohio Attorney General](#) on behalf of the Ohio Public Employees Retirement System as a result of Crisis One ([the 1999-2004 issues](#)). It's an exquisite example of shrewdness necessitated by incompetence. The case is still moving through the courts and expected to go to trial sometime this year.

Back in October of 2008, [PricewaterhouseCoopers agreed to pay \\$97.5 million](#) to settle this litigation. At the time, the Ohio Attorney General's office stated that the \$97.5 million settlement was "one of the 10 highest settlements to be paid by an accounting firm to settle a securities fraud class action." The case was [filed back in 2004](#).

Only one problem... The class has not yet been certified and the settlement has not yet been finalized.

However, after “settling” with Ohio and extricating themselves unofficially from the suit, **PwC quietly agreed to “flip” its witnesses to benefit the plaintiffs** while continuing to serve as AIG’s auditors. Messrs. Winograd and Mayock were recently deposed, in support of the plaintiffs.

A Prisoner's Dilemma: AIG and Goldman Sachs Game Each Other And PwC

Feb 18th, 2010

Jimmy Dell: *I think you'll find that if what you've done for them is as valuable as you say it is, if they are indebted to you morally but not legally, my experience is they will give you nothing, and they will begin to act cruelly toward you.*

Joe Ross: *Why?*

Jimmy Dell: *To suppress their guilt.*

The Spanish Prisoner, *Written and Directed by David Mamet, 1997*

From [Wikipedia](#):

“The **prisoner's dilemma** is a fundamental problem in **game theory** that demonstrates why two people might not cooperate even if it is in both their best interests to do so....If we assume that each player cares only about minimizing his or her own time in jail, then the prisoner's dilemma forms a non-**zero-sum** game in which two players may each cooperate with or defect from (betray) the other player. In this game, as in most game theory, the only concern of each individual player (prisoner) is maximizing his or her own payoff, without any concern for the other player's payoff.”

Gretchen Morgenson and [Louise Story](#) of the [New York Times](#) [told us on February 6, 2010](#) that Goldman Sachs aggressively pushed AIG to the edge of liquidity by repeatedly demanding cash. A longstanding dispute over the value of securities that were covered by credit default insurance sold by AIG to Goldman Sachs had reached a crucial climax:

“Billions of dollars were at stake when 21 executives of [Goldman Sachs](#) and the [American International Group](#) convened a conference call on Jan. 28, 2008, to try to resolve a rancorous dispute that had been escalating for months.

A.I.G. had long insured complex mortgage securities owned by Goldman and other firms against possible defaults. With the housing crisis deepening, A.I.G., once the world’s biggest insurer, had already paid Goldman \$2 billion to cover losses the bank said it might suffer.

A.I.G. executives wanted some of its money back, insisting that Goldman — like a homeowner overestimating the damages in a storm to get a bigger insurance payment — had inflated the potential losses. Goldman countered that it was owed even more, while also resisting consulting with third parties to help estimate a value for the securities.

After more than an hour of debate, the two sides on the call signed off with nothing settled...”

Finally, on September 15, 2008, AIG cried uncle and capitulated, admitting they could not meet all collateral demands. The federal government bailed out AIG and taxpayer assistance to the company currently totals \$180 billion. [Some](#) have already disputed several assertions in the Morgenson/Story piece on the basis, primarily, that Goldman Sachs was proved right in the end. [Lucas van Praag](#), Goldman Sachs’ spokesperson, refuted most of it in a piece published in the Huffington Post.

Morgenson/Story do a great job of documenting that the dispute between AIG and Goldman Sachs had been going on for a while. Their neat graphic says that AIG first sold

Goldman Sachs insurance on the securities in 2003 and that Goldman Sachs first started asking for more collateral in July of 2007 to respond to what they saw as declines in the value of the underlying securities.

The New York Times

February 7, 2010

Negotiating a Price

In 2007 and 2008, as the housing crisis grew, two big financial firms clashed over valuations of complex mortgage securities.

2003 to 2006

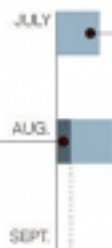
Aug. '03 Goldman creates mortgage securities that the American International Group insures against loss. If the value of the security declines, Goldman can demand money to cover potential losses.

Feb. '06 A.I.G. stops writing insurance protection on securities containing subprime mortgage bonds, because of lax lending practices.

Dec. '06 Goldman begins to increase its negative bets on the mortgage market.

2007

Aug. '07
A.I.G. posts \$450 million to Goldman while the two dispute their valuations of the bonds A.I.G. insured.



July '07
Goldman believes its deals with A.I.G. have declined in value so it demands that A.I.G. turn over \$1.8 billion.

I told you in my [previous post](#) that AIG had been struggling with issues over valuations for a while.

“AIG Crisis One litigation [SDNY, Case No. 04cv8141] is still very much alive. After PwC’s material weakness determination in early 2008, for the 2007 financials, there was an attempt to amend the ongoing suits to include a CDO/CDS cause of action. Research to support this request showed that PwC had been dealing with [closely related accounting issues](#) at AIG as far back as 2002, centered mostly around [EITF 02-3 valuation issues](#). The research revealed deep, longstanding internal controls issues that were now becoming painfully apparent...”

When the Audit Committee of the Board of Directors of AIG met on January 15, 2008, about two weeks prior to the conference call the New York Times cites in the story above, minutes from the meeting say all the big names showed up:

*Present: Messrs. Michael H. Sutton, Chairman, George L. Miles, Jr., Morris W. Offit, Robert Willumstad, ex-officio. Also present were Director Frank G. Zarb, a non-voting member of the Committee, **Messrs. Tim Ryan, Dennis Nally, Henry Dauboney and Michael McColgan from PricewaterhouseCoopers LLP ('PwC')**, Mr. James Cole of Bryan Cave LLP, Mr. James Gamble of Simpson Thacher & Bartlett, LLP, President and Chief Executive Officer Martin J. Sullivan, Executive Vice President and Chief Financial Officer Steven J. Bensinger, Executive Vice President and General Counsel [Anastasia D. Kelly](#), Senior Vice President and Comptroller David Herzog, Senior Vice President and Chief Risk Officer Robert E. Lewis, Senior Vice President and Director of Internal Audit Michael E. Roemer, Senior Vice President Secretary and Deputy General Counsel Kathleen E. Shannon, Vice President-Corporate Governance Eric N. Litzky, Paulette Mullings-Bradnock of Internal Audit, and, for portions of the meeting, Edward diPaolo, John French, Joseph Nocera and Alfred Panasci of Internal Audit.*

For the benefit of those playing at home, the PwC attendees' roles and responsibilities were/are:

- Tim Ryan (Global Relationship Partner for AIG and PwC's [Financial Services Industry Group Head](#) at the time.)
- Michael McColgan (Engagement Partner for AIG)

- Dennis Nally (Chairman and Senior Partner of PwC LLP, the PwC US member firm at the time and now [Global Chairman of PwC](#))
- [Henry Daubenev](#) (Partner in PwC's Banking and Capital Markets Practice, London)

Based on my reading of the Audit Committee minutes, I believe that PwC was aware of weaknesses in internal controls over the AIGFP super senior credit default portfolio throughout 2007 and prior. Why were they pussy footing around still on January 15, 2008 as to whether these control weaknesses were a significant deficiency (which would not have to have been disclosed) or a material weakness (which eventually was)? In fact, at this meeting, PwC was still more concerned about what it saw as an almost inevitable material weakness in controls over AIG's financial close process instead. And for those of you who thought AIG's only significant issue was with Goldman Sachs, I have to tell you, regrettably, this is not so. AIG had a hornet's nest of nagging issues that clearly required high level attention.

*Mr. Ryan commented that the significant deficiency in controls over the financial close process is the most significant deficiency and recapped that at the end of the second quarter there were concerns that without additional management procedures and a **reduction in late adjustments and new errors**, the financial close significant deficiency could rise to the level of material weakness. He indicated that the company had responded in the third quarter financial close and sustaining the fourth quarter close efforts will be important in the year end analysis.*

*Mr. Bensinger then indicated that he, **Mr. Sullivan and Messrs. Ryan and Nally had been meeting regularly to discuss the control matters** and he had asked Mr. Ryan to update the Committee on those discussions. Mr. Ryan then provided the Committee with background on the issues, much of which had been discussed with the Committee in December and in follow-up sessions thereafter with Mr. Sutton. Mr. Ryan commented that following the third quarter close, the PwC team debriefed and assessed a number of issues that had occurred...*

PwC then [goes on to second guess both the 2nd Q disclosures and 3rd Q 2007 disclosures](#) as a result of the financial close control weaknesses and **other major problems** mentioned that had not been disclosed to Executive Management, according to PwC, until it was too late.

“...the collateral issues could have been escalated to the AIG level earlier in the process.”

And, in contrast to what the NYT article stated, AIG seems to have been trying to defend their position on valuations in all AIG business units with subprime exposures. **AIG hired KPMG and Deloitte to conduct an independent review** of their Enterprise Risk Management and AIG operations with subprime exposure and to make recommendations on improving the risk function and on **ways to obtain more information on pricing and valuation**. But PwC would only respond that, *“...further consideration of the super senior credit derivative valuation process is required.”* I did not receive any response to my requests to KPMG and Deloitte spokespersons for information about this review and its results.

By February 7th, the next Audit Committee meeting, PwC had come to the conclusion that a material weakness was going to be cited for the internal controls over the valuation process and not the weaknesses in the financial close process. Senior management was already preparing the ratings agencies, in particular, for a material weakness disclosure. There was grave concern that a ratings downgrade once this disclosure was made would cause additional, perhaps untenable, liquidity stress.

*“Mr. Sullivan asked Mr. Bensinger to update the Committee on the discussions with the ratings agencies in connection with AIG’s proposed filing of a Current Report on Form 8-K regarding AIG’s disclosures in connection with the valuation of the AIGFP super senior credit default swap portfolio and PwC’s views that there was a material weakness in financial control over the valuation process. Mr. Bensinger reported that he and Ms. Watson and Messrs. Dooley and Habayeb had telephone conferences with each of the ratings agencies... Standard & Poors in particular, having a good understanding of these credit markets, put the disclosure in proper perspective, with **their head analyst indicating the belief that other companies would also have to deal with a material weaknesses.**”*

However, I do not recall any other company, and certainly no other PwC client such as JP Morgan, Bank of America, or Goldman Sachs, admitting that their valuation process had been, and still was, weak. Why did PwC decide to point the finger at AIG? Neither AIG nor Goldman Sachs had been willing to defect or betray each other thus far, per the prisoner’s dilemma, even to save them both. The dispute had been going on for more than a month, more than a quarter, more than a

year. It may have been excusable for PwC to allow a mismatch in valuation on the same assets in two of their clients for a month or a quarter due to timing differences in access to information. But a serious, contentious mismatch for more than a year, through several 10Q's, and now going on two 10K's?

So why the push now?

What came next is telling:

“Mr. Bensinger said that pricing inputs had been a spirited discussion topic, with PwC holding the view that AIGFP’s assessment does not include enough consideration of market participants’ views on pricing.”

Market participants’ views on pricing = Goldman Sachs views, in my opinion.

“Mr. Bensinger described the differences of opinion with Goldman Sachs on the pricing of the underlying collateral, noting Goldman’s acknowledged desire to obtain as much cash as possible from their collateral calls. He pointed out that Goldman was unwilling or unable to provide any sources of their determinations of market prices.”

Mr. Bensinger made this statement in front of PwC - Messrs. Daubeney, Robert Sullivan, the [Global Banking and Capital Markets Leader](#) and [Bob Moritz](#), the US Assurance Leader and Managing Partner of the NY Metro Region and now US Chairman and Senior Partner. Plus or minus Dennis Nally and the Goldman Sachs specific Global Relationship and Engagement partners, how much you want to bet these were some of the same guys sitting in on every Goldman Sachs

Audit Committee meeting and hearing the other side of this “difference of opinion” during most of 2007 and all of 2008?

In fact, PwC discouraged AIG from digging too deep into the pricing issue. They wanted AIG to simply adopt the “market participants’ view”:

“Mr. Bensinger emphasized that Management’s objective is to obtain the best estimate of valuation, not necessarily the highest estimate. Mr. Sullivan agreed, noting that AIG had been working diligently to find observability for the spread differential which everyone believes exists. He added that extensive efforts, which he believed were appropriate to meet management’s fiduciary responsibility to shareholders, were not necessarily seen as a positive by PwC, but when it became clear that PwC did not consider the evidence AIG gathered to be adequate from a market observability standpoint, Management decided that the December 31 losses would not include an adjustment for the spread differential.”

In fact, [Andrew Ross Sorkin told us](#) in his book, *Too Big To Fail*, Goldman Sachs was still not satisfied in June of 2008 that PwC was pushing AIG hard enough to consider “market participants’ views” on pricing on a timely or sufficient basis so Goldman could “obtain as much cash as possible from their collateral calls”:

...Sorkin describes a Goldman Sachs June 2008 board meeting where the issue of their collateral dispute with AIG boils over.

“In a videoconference presentation from New York, a PwC executive (PwC is Goldman Sach’s auditor, too) updates the board on its dispute with AIG over how it was valuing or in Wall Street parlance, “marking-to-market,” its portfolio. Goldman executives considered AIG was “marking to make-believe” as Blankfein told the board...the afternoon session proceeded with upbraiding PricewaterhouseCoopers:

“How does it work inside PwC if you as a firm represent two institutions where you’re looking at exactly the same collateral and there’s a clear dispute in terms of valuation?”

How does it work, indeed. Jon Winkelreid, Goldman’s co-president, may or may not have received an answer that day. Sorkin does not report one. I have never heard one.

I still have not heard a specific explanation for how PwC could preside over a long running dispute between two of its most important global clients, a dispute that was material to at least one of them, *obviously*, that had the attention of its highest level partners, and not force a resolution based on consistent application of accounting standards sooner.

I mean... We are talking about valuation of the same assets!

I’ve been writing almost as long as I’ve been writing here that PwC should resign as AIG’s auditor. Was it not enough that PwC had been [sued by AIG shareholders](#) more than once for its role in accounting errors and restatements? Was it not enough that AIG never got corporate governance right and PwC let them get away with it forever? Is it not enough that now [PwC has its own partners testifying against their client](#) on

behalf of plaintiffs they settled with in order to extricate themselves from ongoing expensive litigation?

Is it not enough that PwC was clearly torn between two clients (and maybe more who would have been impacted) who held enormous financial sway and lost its independence and objectivity? I think PwC finally succumbed to Goldman Sachs, selling out AIG while still tippy-toeing around the necessity to finally say which one was closest to complying with standards. Actually taking a consistent stand would potentially implicate other clients such as JP Morgan and Bank of America as well as Freddie Mac in a mark-to-model or rather “mark to make it happen” scandal?

Will someone eventually come forward and tell us that Goldman Sachs sat PwC down in the summer of 2008 and told them, ***“Listen you dweebs, tell those AIG SOBs to cough up! You do whatever you have to do to make them fold! You hear me you milquetoast, muckety-muck, risk averse wienies?”***

And what of the possible collusion amongst the various parties to prop up market prices in the meantime by roundtripping some assets at month- and quarter-end in order to avoid writedowns as long as possible and, therefore, collect those hefty commissions and incentive bonuses?

Stay tuned...

It's Mine, Mine All Mine: Can Anyone Catch Lehman Stealing?

Feb 22nd, 2010

Most of what's been written about the financial crisis and the firms that were forcibly acquired, failed, or bailed out tends to focus on "fair value" as the feckless culprit.

Satyajit Das wrote for the site, Naked Capitalism:

"MtM [mark-to-market] accounting itself is flawed... There are difficulties in establishing real values of many instruments. It creates volatility in earnings attributable to inefficiencies in markets rather than real changes in financial position... Valuation for all but the simplest instruments today requires a higher degree in a quantitative discipline, a super computer and a vivid imagination. For complex structured securities and exotic derivatives, the only available price is from the bank that originally sold the security to the investor. Prices available from the purveyor of the instrument (a concept known as mark-to-myself) strain reasonable concepts of independence and objectivity...In the global financial crisis, with the capital markets virtually frozen, the extent of losses on bank inventories of hard-to-value products and commitments (structured debt and leveraged loans) was difficult to establish."

We know that the banks' "independent" external auditors had a hard time establishing both fair values and the "extent of losses on bank inventories of hard-to-value products and commitments." We know this because their clients did not tell us about the extent of the losses until it was too late. There were no "going concern" warnings for any of the financial

institutions that went bankrupt, were taken over, or were nationalized via bailout.

We also know that the auditors did a poor and [inconsistent](#) job of establishing fair values and forcing disclosure of the “extent of losses” on banks’ investments because [their regulator, the PCAOB, told us so](#).

Inspection teams also observed instances where firms’ procedures to test the fair values of financial instruments, including derivative instruments, loans, and securities, were inadequate. In these instances, deficiencies included (a) the failure to gain an understanding of the methods and assumptions used to develop the fair value measurements of financial instruments that were illiquid or difficult to price, (b) the reliance on issuer-supplied pricing information without obtaining corroboration of that information, and (c) the reliance on confirmation responses from third parties or counterparties that included disclaimers as to their accuracy and appropriateness for use in the preparation of financial statements.

How do the auditors, one step removed and ten steps behind, determine fair values of complex instruments especially in illiquid markets if even the super-bankers couldn’t get it right? This question supposes that it’s the auditors’ obligation to determine the values and that the bankers didn’t get it right.

Neither is true.

What are the auditors’ obligations with regard to clients’ fair value measurements and disclosures? Auditors do not establish fair values. Instead, their role is to, “*test management’s fair value measurements and disclosures.*” But

that obligation is broader than just taking the word of the [“masters of the universe.”](#)

The auditor should consider using the work of a specialist if the auditor does not have the necessary skill and knowledge to plan and perform audit procedures related to fair value.^[1] Observable market prices may exist to assist in testing fair values. Where they do not and other valuation methods are used, the auditor’s substantive tests of fair value may involve (a) testing the significant assumptions, the valuation model, and the underlying data, (b) developing an independent estimate of fair value for corroborative purposes or, where applicable, (c) reviewing events or transactions occurring after the period covered by the financial statements and before the date of the auditor’s report.^[2]

I say it’s outrageous to see [ongoing material “disputes”](#) regarding the fair value of complex derivatives between counterparties, especially if they are clients of the same auditor. Critics have suggested that I condone breaches of client confidentiality. Without betraying client confidentiality, they ask, how can distinct audit teams compare the values assigned to either side of same transaction?

One of my [commenters explained it:](#)

Just how many PhD’s with CDS valuation expertise do you think PwC has lying around in New York? The valuation of these instruments and the testing of the assumptions would have been sent to a centralized derivative valuation group to review and test. Such a team would have had a fairly standard set of guidelines and testing approach regardless of the team sending it. After validating the inputs, they would have likely put

it through their own sausage machine / valuation tool and compared the results. I think there would be a high probability that the same analysts would have been reviewing the same instrument for both GS and AIG. And when they notice that GS is using market derived inputs for the referenced MBS while AIG is using the historical average default rates and ignoring the market you would have hoped they might speak up. And when the partner (finally) heard the rumblings of a problem, even after it has been filtered through the manager / senior manager “make-it-go-away” screen, he would have asked “who else deals with this cr_p in the firm? GS... ah, [insert name of old white guy here] is an old buddy of mine, I’ll just give him a call and ask him what they do...”

When one excuses the auditors for not getting fair value right, there’s a follow-on argument that claims no one got it right. No one *could possibly* get it right. That’s why the crisis occurred. That’s what the scoundrels that benefited most from the crisis would like you to believe.

Reality is the opposite.

[Much has been written](#) about how well Goldman Sachs made out as a result of the crisis. But there are others. Some are getting prosecuted like [Bank of America’s Ken Lewis](#) for hiding losses to further their interest in millions of bonus dollars. That’s why some are starting to use the word “fraud” when speaking of Lehman’s collapse.

On February 11th, [Bloomberg’s Jonathan Weil](#) asked why no one is prosecuting Lehman Brothers executives for fraud:

It is so widely accepted that Lehman Brothers Holdings Inc.’s balance sheet was bogus that even former Treasury Secretary

Hank Paulson can say it in his new memoir. And still, the government hasn't found anyone who did anything wrong at the failed investment bank...In his new book, "On the Brink," Paulson doesn't point fingers at specific Lehman executives for violating any rules. He displays amazing candor, though, in describing how Lehman's asset values were a gross distortion of the truth. It doesn't take much imagination to figure out they didn't get that way all by themselves."

A reader, I'll call him **David the CFE**, repeats a story to me to illustrate this point:

"Casey Stengel probably said it best when he said after the Mets 40-120 season, 'Gentlemen, not one of you could have done this on your own. This was a team effort.'"

Losing \$156 billion requires a team effort.

When former Lehman Managing Director [Arthur Doyle](#) reviewed [Larry McDonald's book on Lehman](#), he asked the same questions about fraud and Lehman executives:

"The most important questions of all are not even asked in "A Colossal Failure of Common Sense," or in any other account I have so far seen of the Lehman failure. Simply put, how did Lehman's published financial statements, as recently as its final 10-Q published in July of 2008, show a positive net worth of \$26 billion, when the bankruptcy liquidators are saying that they are looking at a negative net worth of \$130 billion? Doesn't any or all this constitute securities fraud? And shouldn't there be criminal liability for the executives who signed the firm's 10-K and 10-Q's, who under Sarbanes-Oxley are responsible for material misstatements made in those documents?"

[Bloomberg's Weil has a theory](#) about why these crimes are not being prosecuted:

“There’s been much talk the past two years about moral hazard, which is the risk that companies and their investors will behave more recklessly when they believe the government will bail them out. Less has been made of a similar hazard: The danger that powerful companies won’t follow the law when their executives believe the government won’t hold them to it...The latter risk threatens not only our economy, but our democracy. There’s every reason to believe both kinds are growing.”

David the CFE and I have another theory:

Collusion.

The crimes are too numerous to prosecute without indicting the whole system and most of the major players. And because they were part of the problem before they were theoretically part of the solution, culpability also attaches to Paulson and Tim Geithner.

David the CFE's theory is premised on some of the oldest tricks in the book for [manipulating revenue recognition](#) and, therefore, reported profits and incentive compensation payouts including stock options - [roundtrips, parking, and channel stuffing](#). In another variation on the theme, global trading company Refco used [a round trip loan](#) to repeatedly hide a related-party transaction incurred to delay disclosure of significant uncollectible accounts. It's not like these techniques haven't been used before (by AIG, for example) to offload risk and smooth earnings at quarter- and year-end.

[“This case](#) shows that the Commission will pursue insurance companies and other financial institutions that market or sell so-called financial products that are, in reality, just vehicles to commit financial fraud,” said Stephen M. Cutler, director of the SEC’s Division of Enforcement.

With regard to the financial crisis, these revenue recognition fraud techniques may have been most useful in establishing [“observability”](#) of market prices for otherwise illiquid assets. Establishing “market prices” via fraudulent, sham transactions amongst the market participants before quarter-end and year-end reporting periods would have allowed assets to remain on the books longer at inflated values and, therefore, to inflate profits and bonuses. “Market prices” that appeared to support existing valuations sustained the myth. The investments were not written down until long after the market for subprime real estate securities started to wilt.

David the CFE explains this theory in the case of Lehman Brothers:

[Nassim Taleb](#) says about banks: *“Banks hire dull people and train them to be even duller. If they look conservative, it’s only because their loans go bust on rare, very rare occasions. But bankers are not conservative at all. They are just phenomenally skilled at self-deception by burying the possibility of a large, devastating loss under the rug. [Taleb](#) further states: “Executives will game the system by showing good performance so they can get their yearly bonus.”*

Lehman paid out \$5.2 billion in bonuses in 2006 and \$5.7 billion in bonuses in 2007. Did this result from the executives at the bank gaming the system to increase their bonuses? An

example of burying a large loss under the rug can be found in this excerpt from Lehman Brothers in its [2006 10-K](#):

*We held approximately \$2.0 billion and \$0.7 billion of non-investment grade retained interests at November 30, 2006 and 2005, respectively. Because these interests primarily represent the junior interests in securitizations for which there are not active trading markets, estimates generally are required in determining fair value. We value these instruments using prudent estimates of expected cash flows and consider the valuation of **similar transactions in the market**.*

Junior interests in securitizations. Lehman and other firms purchased mortgages that would effectively be resold by them as collateralized debt obligations. Each of Lehman's securitizations was broken into tranches in which senior interests received greater preference with respect to collections of interest and principal than junior interests that were entitled to greater profits, if such profits were realized. A junior interest in a securitization is the lowest level of the tranches for collateralized debt obligations. Generally, only the [bottom 3% of a securitization was labeled as equity](#).

During 2006, housing prices dropped nationally by at least 5% from the spring of 2006 to Lehman's Nov. 30, 2006 and the default rate was increasing as well. With prices of houses dropping and the default rate increasing, there was a risk of large losses when the buyer defaults. Thus, the junior interests in securitizations that Lehman was purportedly investing in were probably already worthless at the time that Lehman invested in them or at November 30, 2006.

An auditor would have to suspect a material loss is being hidden and that collusion between several departments at Lehman Brothers and management's participation in the deception was possible. [Ernst and Young](#), Lehman's auditors, were probably unwilling to consider such a possibility because auditors accept as dogma that collusion between many employees and multiple departments is unlikely no matter what the motive, i.e., \$5.2 billion in bonuses. Auditing standards also do not consider collusion likely. Apparently, auditors did not consider the possibility that two different groups at Lehman Brothers such as the underwriters who sold the securitization IPOs and the trading departments would collude to hide a \$1.3 billion loss in a junior equity position that could not be sold.

Hiding losses on CDOs and mortgages purchased for securitization. A reasonable question to ask was: If Lehman Brothers started the fiscal year ending Nov. 2007 with \$57 billion of CDOs and held them for the year, what would their estimated loss be? Also: What would the additional loss be with \$32 billion in CDOs and/or mortgages purchased?

Presumably, the losses would be in the range of \$10 billion to \$30 billion. By Nov. 2007, everyone knew of the problems with CDOs. Bear Stearns had already closed two hedge funds investing in CDOs. Merrill Lynch had made huge write downs and forced out its CEO. My guess is that Lehman Brothers engaged in schemes to fool the auditor in order to avoid disclosing losses from their securitizations and investments in CDOs.

Lehman probably pulled a variation of the old [“telecom swap.”](#) In the “telecom swap” cases, one telecom company would sell telecom capacity to another telecom and then purchase the

same amount of telecom capacity from the other party. The firm selling the capacity would book the amount received as revenue and the firm purchasing the capacity would book the amount received as a fixed asset. It worked very well in creating fictitious profits for those firms.

That same trick could be used by financial institutions in the case of CDOs/CDSs. Let's say Financial Institution A sells collateralized debt obligations with a true fair market value of 90 million to Financial Institution B for 100 million dollars in cash. Financial Institution B purchases collateralized debt obligations with a true fair market value of 90 million dollars from Financial Institution A for 100 million dollars in cash.

And then those phony trades are shown as the **“observable” similar transactions in the market.**

Did the auditors check for this item? Probably not. Why not? Because it's an example of collusion between Lehman and other companies. Auditors don't check for collusion no matter how many times they get fooled by it!

Incentivizing fraud. Auditors, especially inexperienced ones, think management has to actually tell someone if they want to overstate their income. Auditors and the judges that try these cases want to find “smoking gun” memos and emails that say, “Overstate income so we can all get our bonuses and keep our jobs.” But all top management really has to do is tell each unit head that: (a) you and your employees will get large bonuses if your unit reaches its profit goals and, (b) you will not receive a bonus if your unit doesn't achieve its goals. Then management promotes only those who meet those goals – regardless of how they meet them.

In other words, each manager within the Lehman brokerage unit had a major incentive to reach his profit goals. And, each employee who worked for those managers also has that incentive because his bonus and promotions are based on meeting those goals, too. Thus, management doesn't have to direct its employees **directly** to commit fraud. They can claim plausible deniability because they rather passively allow the employees create their own frauds. Employees who understand the system will game that system by working with others in the organization and outside the organization to produce fake profits.

[1] AU 328, Auditing Fair Value Measurements and Disclosures, paragraphs 20 and 23; AU 332, Auditing Derivative Instruments, Hedging Activities, and Investments in Securities, paragraph 06. Also, in December 2007, in response to the auditing challenges presented by the subprime credit crisis and the transition to the new fair value accounting standard, the PCAOB staff issued Staff Audit Practice Alert No. 2, Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists (December 10, 2007), which provides auditors with information about auditing fair value measurements and disclosures.

[2] AU 328.23; AU 332.40

In Pari Delicto: Are Auditors Equally At Fault In The Big Fraud Cases?

Mar 9th, 2010

Category: [AIG](#), [Fraud](#), [Latest](#), [Pure Content](#), [The Case Against The Auditors](#)

The phrase *in pari delicto* sounds like something dirty to me. Maybe I'm still preoccupied with the [accusation](#) that I'm producing accounting pornography.

"...the etymology of the term [pornography] is: "Etymology: Greek pornographos, adjective, writing about prostitutes, from porn prostitute + graphein to write; akin to Greek pernanai to sell, porosjourney"

That implies accounting porn is writing about accounting prostitutes. That being the case, then Francine McKenna, Sam Antar, Tracy Coenen and Bob Jensen all engage in accounting porn. They write about the corporate executives and audit firm partners that prostitute their accounting reports in the search for fictitious profits and all too real unearned bonuses. In other words, accounting fraud is accounting prostitution..."

In pari delicto, for those of you not lawyers or legal argument junkies like me, is "Latin for "in equal fault". It's a legal term used to indicate that two persons or entities are equally at fault, whether we're talking about a [crime](#) or [tort](#). The phrase is most commonly used by [courts](#) when relief is being denied to both parties in a [civil action](#) because of wrongdoing by both parties. The phrase means, in essence, that since both parties are equally at fault, the court will not involve itself in resolving one side's claim over the other, and whoever possesses whatever is in dispute may continue to do so in the absence of a superior claim."

There are two active cases where this doctrine and defense is being employed by auditors trying to avoid liability for fraud.

In *Teachers' Retirement System of Louisiana v. PricewaterhouseCoopers LLP*, No. 454, 2009 (Del. March 4, 2010), one of many AIG suits that PwC is involved in directly or indirectly, the Delaware Supreme Court used a procedure provided for under the New York Rules of Court to [certify a question of law to New York's highest court, the New York Court of Appeals](#). This matter involves an appeal from the Delaware Court of Chancery regarding the oft-cited AIG case which denied a motion to dismiss claims against the top officials of AIG for breach of fiduciary duty based on Delaware law. However, the claims against the auditor, PwC, were dismissed based on New York law. The Plaintiffs are appealing the Chancery Court's decision regarding PwC. (Summary borrowed for accuracy from Francis Pileggi at [Delaware Litigation.com](#) who alerted me to this most unusual move by the Chancery Court.)

The Court of Chancery held that the claims against PwC were governed by New York law, and that based on the allegations of the Complaint, AIG's senior officers did not "totally abandon[]" AIG's interests—as would be required under New York law to establish the "adverse interest" exception to imputation. Accordingly, the Court of Chancery held that the wrongdoing of AIG's senior officers is imputed to AIG.³ The Court of Chancery concluded that, once the wrongdoing was imputed to AIG, AIG's claims against PwC were barred by New York's in pari delicto doctrine and by the related Wagoner line of

standing cases in the United States Court of Appeals for the Second Circuit.

This Court hereby certifies the following question to the New York Court of Appeals:

*Would the doctrine of **in pari delicto** bar a derivative claim under New York law where a corporation sues its outside auditor for professional malpractice or negligence based on the auditor's failure to detect fraud committed by the corporation; and, **the outside auditor did not knowingly participate in the corporation's fraud, but instead, failed to satisfy professional standards in its audits of the corporation's financial statements?***

The other case where the **in pari delicto** defense has tied the litigation into knots and caused some stops and starts is in *Kirschner v. KPMG LLP et al.*, case number 09-2020, in the U.S. Court of Appeals for the Second Circuit which is about the [Refco fraud](#). The [Second Circuit certified the questions](#) about an exception to the **in pari delicto** defense. Now they have two high profile cases against auditors to consider.

From [Law360.com](#): Not one to go down easy, the bankruptcy trustee for [Refco Inc.](#) brought his suit implicating [Mayer Brown LLP](#), [KPMG LLP](#) and other corporate giants in the massive Refco fraud to a federal appeals court...The U.S. Court of Appeals for the Second Circuit found Monday that trustee Marc S. Kirschner's fight to revive his claims against the clutch of corporate insiders raised critical unresolved questions concerning the bankruptcy trustee's standing under New York law to sue third parties for Refco's fraud.

The trustee alleges outside counsel Mayer Brown, auditors [Ernst & Young LLP](#), [[Grant Thornton](#)] [PricewaterhouseCoopers](#)LLP, Banc of America Securities LLC and several other insiders are liable for defrauding Refco's creditors, namely by helping the defunct brokerage conceal hundreds of millions of dollars in uncollectible debt.

Steve Jakubowski, a local Chicago lawyer who writes the [Bankruptcy Litigation Blog](#), sponsored a [guest post in January by Catherine Vance](#), one of the fiercest critics of the "expansive" use of the *in pari delicto* defense. He introduces her post this way:

*[Whatever you may think](#) about the fact that Refco's outside corporate counsel, Joe Collins, was convicted on 5 criminal counts and [sentenced today to 7 years in prison](#), one has to wonder how the system got so turned upside down on the civil side that while the law firm's lead lawyer is torched in criminal court, his firm is summarily dismissed from a civil case for precisely the same conduct on a simple motion to dismiss (based on a theory that [the Refco trustee lacked standing to bring suit to recover for damages arising from a fraudulent scheme devised and carried out by Refco's own senior management](#)). One could argue that this result is unique to the Second Circuit ([and the Seventh](#)) because of the Wagoner decision and its progeny ([which are not followed in the First, Third, Fifth, Eighth, or Eleventh Circuits](#)). Even in those circuits, however, management's wrongful conduct has been imputed to the corporation under the *in pari delicto* doctrine to just as effectively knock the props out from civil actions involving some of the most spectacular commercial frauds of the century.*

Ms. Vance wrote an article entitled, [*In Pari Delicto, Reconsidered*](#), in which she posited—as none had before—that the *in pari delicto* doctrine is being inappropriately used by federal courts to supplant traditional tort law defenses that derive from state, not federal, law.

The way I see it, the *in pari delicto* doctrine is being used like a pair of needle nosed pliers by audit firm defense lawyers to diffuse a bomb – huge liability for some of the biggest frauds in history. The *in pari delicto* doctrine attempts to pull the auditors’ tails from the fire by excusing any of their guilty acts due to the approval of those acts by potentially equally guilty executives. The law allows these executives to continue to “stand in the shoes” of the shareholder plaintiffs even after their guilt has been determined. The theory is that the executives perpetrated the fraud for the benefit of the corporation and never “totally abandoned” it, as would be required for the “adverse interest” exception.

Auditors who should otherwise be tested on their fulfillment of their public duty are instead getting reprieves because courts have been unwilling to impose the [“adverse interest”](#) exception as expansively as they have the *in pari delicto* defense itself. How can executives who are successfully sued, been subject to regulatory sanctions or, in the case of the Refco executives, plead guilty to criminal activities, still be considered representatives of the corporation’s interests? They should forfeit the right to stand in the shoes of the corporation’s shareholders in derivative suits and therefore to shield other potentially guilty or negligent parties.

The situation gets complicated in a bankruptcy case such as Refco since, traditionally according to [Section 541 of a decision](#)

called *In re PSA, Inc.*, “property of the bankruptcy estate consists of all legal or equitable interests of the debtor, including causes of action, as of the commencement of the bankruptcy case. A bankruptcy estate’s causes of action, therefore, as well as the attendant defenses thereto, transfer to the bankruptcy trustee frozen and fixed as they existed at the commencement of the bankruptcy case. As a result, an “innocent” bankruptcy trustee “stands in the shoes” of the pre-petition debtor and may be unable to prevail on estate causes of action where the pre-bankruptcy debtor participated or was complicit in the wrongful acts upon which the estate attempts to sue.”

A trustee in bankruptcy must have standing to sue anyone on behalf of the creditors and other injured parties. Unfortunately, this habit of allowing guilty parties to continue to drive the bankruptcy bus by having the actions of the guilty officers “imputed” to the corporation and, therefore, in bankruptcy to the trustee potentially threatens the trustee’s ability to sue “co-conspirators.”

It’s just nuts.

Akin Gump summarizes critics of this line of reasoning this way:

The purpose of the in pari delicto defense, they argue, is to prevent a party who is complicit in wrongdoing from prevailing against their joint actors. In their view, the intercession of an innocent trustee whose duty it is to maximize the value of the estate for the debtor’s creditors purges the taint of the debtor’s wrongdoing, and that to hold otherwise would simply elevate

the legal fiction of section 541 over the purpose of the in pari delicto defense.

Ms. Vance reminds us in her [treatise](#) that *in pari delicto* was ushered into modern bankruptcy jurisprudence as a part of the [deepening insolvency](#) discussion. I've written about deepening insolvency many times as it relates to the auditors who, by continuing to provide false and negligent clean audit opinions, allow a company to go deeper and deeper into debt and ruin, thereby significantly diminishing any remaining value for stakeholders once the gig is up.

The *deepening insolvency* arguments have been [shot down](#) by no less than [Judge Posner](#) whose pernicious pragmatism forces him to engage in the self-delusion that helping companies remain “viable” via fraud doesn't hurt anyone. This fantasy presupposes the company to be a person and not the embodiment of the goals and objectives, hopes and dreams, faith and trust of the shareholders, employees, creditors, and community that count on it to continue legally and honorably instead. I suppose a [Supreme Court that allows corporations to donate money to political campaigns](#) in an exercise of their inalienable constitutional rights would not find this idea so strange.

When [Francis Pileggi sent me the update](#) on the AIG case, *Teachers' Retirement System of Louisiana v. PricewaterhouseCoopers LLP*, he asked me how I thought the New York Court of Appeals would rule. Given that there are two very similar cases facing the court on the *in pari delicto* doctrine, both with significant implications for future suits against auditors in fraud cases, I am hoping the justices consider the public interest carefully. If they do, I hope they will

see that there is no public interest served in shielding additional guilty parties when a massive fraud is perpetrated against shareholders and other stakeholders.

For PwC, there is a significant implication for their [Satyam fraud suits](#) in New York courts. How much better does it get than to have your client and several of his executives in jail too, having confessed to the fraud for which you are also accused by shareholders in a derivative suit of being complicit?

BTW: [Grant and Eisenhofer P.A is co-lead Plaintiffs' counsel](#) for the consolidated [Satyam securities class action](#) and the Plaintiff's counsel on Teachers' Retirement System of Louisiana v. PricewaterhouseCoopers LLP. To be honest, I think the filings for Satyam are still quite "rustic" on the PwC International firm and related issues.

I am not optimistic. I have seen too many cases decided on esoteric points of archaic law that serve no purpose but to stroke the justice's egos and to perpetuate the false hope of the sham auditor's opinion.

I appeal to the New York Court of Appeal to do right.

Otherwise...

Quis custodiet ipsos custodes?

Good News. Bad News. AIG's Cassano Snitches On PwC

Apr 7th, 2010

The US Federal government has been propping up AIG with hundreds of billions of dollars and AIG has been, in turn, protecting its auditor, PricewaterhouseCoopers (PwC).

PwC continues to be AIG's auditor.

Unfortunately for all of them, former AIG Financial Products head, Joe Cassano, is off the reservation and worried more about his own scalp. After two years of negotiations with the Department of Justice, it looks like he won't be criminally prosecuted for hiding risks from investors or lying at a December 2007 investor conference. In spite of the fact he cut internal auditors out of the process, it turns out **he did** tell PwC about the growing risks and "required" accounting adjustments in the credit default swaps portfolio early in 2007. PwC's own notes show that they knew all about the risks that Cassano's Financial Products Group long before the infamous, "Everything is fine," presentation to investors in December 2007..

The Wall Street Journal: "As of last fall, authorities believed Mr. Cassano may not have properly disclosed the adjustment to PwC, people familiar with the matter have said.

But in a series of meetings last fall, Mr. Cassano's lawyers insisted to federal prosecutors that he had been forthright about the adjustment...Prosecutors have since obtained notes written by a PwC auditor from a November 2007 meeting that appear to show Mr. Cassano informed the auditor

about the adjustment and its potential positive impact... That would make it difficult to bring a strong criminal case against Mr. Cassano.”

That’s consistent with [what I read](#) in AIG Audit Committee Meeting minutes from January 15th, 2008. Attending the meeting from PwC:

- *Tim Ryan (Global Relationship Partner for AIG and PwC’s [Financial Services Industry Group Head](#) at the time.)*
- *Michael McColgan (Engagement Partner for AIG)*
- *Dennis Nally (Chairman and Senior Partner of PwC LLP, the PwC US member firm at the time and now [Global Chairman of PwC](#))*
- *[Henry Daubeney](#) (Partner in PwC’s Banking and Capital Markets Practice, London)*

I believe that PwC was aware of weaknesses in internal controls over the AIGFP super senior credit default portfolio throughout 2007 and prior.”

Why did I say that back in February? Because of this excerpt:

*“Mr. Bensinger [AIG CFO] then indicated that he, Mr. Sullivan [AIG CEO] and Messrs. Ryan and Nally had been meeting regularly to discuss the control matters...Mr. Ryan commented that following the third quarter close, the PwC team debriefed and assessed a number of issues that had occurred, such as the securities lending program and the operation of AGF, Inc., **the AIG Financial Products Corp super senior credit default swap portfolio** and disclosure issues in the presentation of maximum exposures of UGC...”*

PwC is cooperating not [only with plaintiff's attorneys in the suits against AIG](#) but with the Department of Justice. However, this particular "voluntary" disclosure by PwC makes them look bad and tells me AIG executives lied. Take a look at this story from [May of 2008](#):

[*Pricewaterhouse's Squeeze Play
AIG Says It Misled Auditor, As Greenberg Cites Review
Clearing Internal Controls*](#)

*American International Group Inc.'s lengthened laundry list of accounting woes shines the spotlight more brightly on the role played by its outside auditor, PricewaterhouseCoopers LLP... The insurer's latest release **offered some relief for the accounting firm**: It noted that "in certain instances," improperly booked transactions "may also have involved misrepresentations to management, regulators **and AIG's independent auditors.**"...Pricewaterhouse wasn't told in full about AIG's ties to or dealings with two offshore reinsurance companies that AIG, because of the internal reviews, now plans to consolidate into its financial statements...AIG also acknowledged that [former executives at times had been able to "circumvent internal controls over financial reporting."](#)*

If Cassano did tell PwC all about the Financial Products Group activities, and AIG told PwC about [all of their control issues throughout 2007](#) and prior, what are the legal implications for PwC? PwC [knew about and blessed AIG's subterfuges](#) until they couldn't – the ["negative basis adjustment"](#) was an accounting trick.

AIG publicly said PwC had been duped. Now PwC is giving up workpapers and private notes that say they weren't duped, ***without a legal fight?***

What else does PwC have on AIG?

Or AIG on PwC?

Joe Cassano is no longer playing this game.

Isn't it time, finally, for regulators to force PwC to resign as AIG auditor? They have no independence or objectivity when it comes to "client" AIG.

Fraud Happened: The No-Account Accountants Stood By

Apr 18th, 2010

The financial crisis is now about fraud.

The [word that dared not be uttered](#), even behind closed doors, has now disturbed the peace of a nascent “recovery.” Why did it take so long for the media, [the regulators](#) and the legislators to acknowledge what [some of us have known](#) for a while?

“Gentlemen, not one of you could have done this on your own. This was a team effort.” *Casey Stengel after the Mets 40-120 season.*

Why didn't the Big 4 audit firms warn that these obscenely over leveraged institutions threatened our financial future? Why didn't the auditors question, push back, or raise objections to illegal and unethical disclosure gaps? Every one of the failed or bailed out financial institutions carried non-qualified, clean audit opinions in their wallets when they cashed the taxpayers' check.

Lehman Brothers. Bear Stearns. Washington Mutual. AIG. Countrywide. New Century. Citigroup. Merrill Lynch. GE Capital. GMAC. Fannie Mae. Freddie Mac.

The largest four global audit firms – Deloitte, Ernst & Young, KPMG and PricewaterhouseCoopers – have combined revenues of almost \$100 billion dollars and employ hundreds of thousands of people. There's no hard proof they're completely corrupt, but they've proven themselves to be demonstrably self-interested and no longer singularly focused on their public duty to shareholders.

Something is rotten with the accounting industry.

America's public accountants – in particular, the Big 4 audit firms – aren't protecting investors. And no one is holding them accountable.

The crisis that culminated in the near-collapse of the global financial system is still the subject of Congressional hearings.

Almost every player has been called to account.

Except one.

The auditors.

Last month the [Lehman Bankruptcy Examiner's report](#) told us that there's "*sufficient evidence exists to support colorable claims against Ernst & Young LLP for professional malpractice arising from [their] failure to follow professional standards of care.*"

[This week](#) the Securities and Exchange Commission charged Goldman Sachs and one of its vice presidents with fraud for misleading investors by "misstating and omitting key facts about a financial product tied to subprime mortgages."

That financial product was a structured collateralized debt obligation (CDO) that hinged on the performance of subprime residential mortgage-backed securities (RMBS). Goldman Sachs, according to the SEC, failed to disclose vital information about the CDO to investors. In particular, John Paulson's hedge fund, a Goldman client, played a leading role in the [portfolio](#) selection process and the hedge fund took a short position against the CDO, without disclosure to Goldman's other clients.

In one of the most egregious cases of auditor complacency during the financial crisis, Pricewaterhouse Coopers LLP (PwC), the firm that audits both AIG and Goldman Sachs, sat on the sidelines for almost two years while their clients disputed the value of credit default swaps (CDS).

There's been no public explanation of how PwC presided over [the dispute between AIG and Goldman](#)—a dispute eventually pushed AIG to accept a bailout – without doing something decisive to help resolve it. This long-running “difference of opinion” between two of its most important global clients was arguably material to at least one of them. Why didn't PwC force a resolution sooner based on consistent application of accounting standards?

PwC was paid a combined \$230 million by the two firms for 2008 and remains the “independent” auditor to both companies.

Gatekeepers? Or foxes in the hen house?

The auditor's role is to be a gatekeeper. A watchdog. An advocate for shareholders. This is their public duty.

This public trust is subsidized by a government-sponsored franchise. All companies listed on major stock exchanges *must* have an audit opinion. Audit firms are meant to be shareholders' first line of defense, and they are hired by and report to the independent Audit Committee of the Board of Directors.

And yet the same audit firms that stood by and watched Bear Stearns and Lehman Brothers fail – Deloitte and Ernst & Young – are recipients of lucrative government contracts to audit or

monitor the taxpayers' investment in the bailed out firms. Deloitte, the Bear Stearns and Merrill Lynch auditor, works for the US Federal Reserve system. Ernst & Young, Lehman's auditor, is working for the US Treasury on the original \$700 billion TARP program and with the Fed on the AIG bailout.

Who are we kidding?

America's auditors serve themselves. Focused on "client service" not shareholder advocacy, they've remained above the financial crisis finger-pointing fray. Call it skillful lobbying or [targeted political contributions](#)... Either way, regulators and legislators have been afraid of getting on the auditors' bad side.

Investment banks, mortgage originators, commercial banks, and ratings agencies have all been questioned about their role in the crisis. And the Big 4 public accounting firms work for all of them.

But when accused of negligence, malpractice or complicity, the audit firms frequently claim to have been duped. Do you believe them? The industry is an oligopoly. That's a \$10 word for what happens when a [market](#) or [industry](#) is dominated by a small number of sellers who discuss their strategies in order to achieve common objectives.

The Sarbanes Oxley Act of 2002 (SOx) was enacted after the Enron debacle to restore confidence in the audit profession. Instead, accounting firms reaped huge financial rewards while enforcing SOx, until the tremendous cost to America's businesses forced regulators to lighten up and the auditors to stand down.

But SOx had another insidious byproduct: the misplaced belief that after Arthur Andersen's implosion, the remaining four global public accounting firms were too important, and too few, to fail.

This fear of auditor failure precludes any regulatory or legislative actions that might precipitate the loss of another large accounting firm. What do you get when there's no timely or significant regulatory consequence to repeated auditor malpractice and incompetence? Moral hazard. "Too few to fail" has been as detrimental to capital markets as the notion that some financial institutions are too big to fail. Shareholders are harmed and investors lose confidence.

Every one of the audit firms is a defendant in lawsuits for institutions that failed, were taken over, or bailed out, in addition to several \$1 billion plus malpractice, fraud and Madoff-related lawsuits. Any one of these "catastrophic" matters could threaten their viability. However, regulators and the worldwide business community are ignoring this threat or, worse yet, promoting liability caps. Limiting liability only exacerbates moral hazard.

Can a crisis caused by "catastrophic" disruption in audit service delivery be any worse than the one they never warned us about? Why not face fears head on and start re-writing the audit blank check – ineffective audit opinions – before the plaintiffs' bar does it for us?

What A Tangled Web We Weave: AIG's Cassano Says He Told PwC Everything

Jun 30th, 2010

Joseph Cassano, the former head of AIG's Financial Products Group, testifies today for the [Financial Crisis Inquiry Commission](#), a bipartisan commission with a critical non-partisan mission — to examine the causes of the financial crisis.

“He headed up AIG Financial Products,” [Phil Angelides](#), chairman of the bipartisan commission, said Tuesday. “He was at the center of this. He was a person extra-knowledgeable about the inner workings of that company and its relationship with others.”

The [Department of Justice](#) cleared Mr. Cassano in May. No criminal charges will be filed. [U.K.'s Serious Fraud Office](#) dropped probes last month, and the [U.S. Securities and Exchange Commission also closed](#) their investigations too. Mr. Cassano was villainized by the press and his own former company for not keeping anyone informed of the potential losses on his portfolio and making misleading statements to investors including the auditors, PricewaterhouseCoopers.

But the investigations went aground [when](#), *“prosecutors found evidence Mr. Cassano did make key disclosures. They obtained notes written by a PwC auditor suggesting Mr. Cassano informed the auditor and senior AIG executives about the adjustment...[and] told AIG shareholders in November 2007 that AIG would have “more mark downs,” meaning it would lower the value of its swaps.”*

So who's telling the truth? Was PwC duped by AIG? Who is looking out for AIG shareholders and now, the US taxpayer in this mess?

“Based on my reading of the Audit Committee minutes, I believe that [PwC was aware of weaknesses in internal controls over the AIGFP super senior credit default portfolio throughout 2007 and prior.](#) Why were they pussy-footing around still on January 15, 2008 as to whether these control weaknesses were a significant deficiency (which would not have to have been disclosed) or a material weakness (which eventually was)?”

Cassano says he told the auditors everything. Unfortunately for AIG and PwC, that excuse is contradicted by AIG's statements during an earlier, similar crisis in disclosures and accounting. Why didn't the Department of Justice and the SEC see this pattern of cover-up between AIG management and its auditors and the lack of independence of the auditors, PwC?

The Wall Street Journal in May of 2005: Pricewaterhouse's Squeeze Play

AIG Says It Misled Auditor, As Greenberg Cites Review Clearing Internal Controls

The insurer's latest release offered some relief for the accounting firm: It noted that “in certain instances,” improperly booked transactions “may also have involved misrepresentations to management, regulators and AIG's independent auditors.”

Specifically, the company said Pricewaterhouse wasn't told in full about AIG's ties to or dealings with two offshore reinsurance

companies that AIG, because of the internal reviews, now plans to consolidate into its financial statements... Although Pricewaterhouse received a subpoena from the SEC in February seeking documents about AIG, regulators aren't focusing on the accounting firm... AIG also acknowledged that former executives at times had been able to "circumvent internal controls over financial reporting." As a result, AIG said Pricewaterhouse likely will fault the insurer's internal financial controls in the annual report to come even as it is likely to give the insurer "unqualified" opinions on its financial statements as well as its assessment of its internal controls...AIG said one reason its internal controls didn't pass muster was the ability of "senior management" to get around the safeguards. "

PricewaterhouseCoopers has been playing consigliere to AIG for many, many years and continues to be allowed to act as their "independent" auditor in spite of the fact that they have been sued by AIG's shareholders and are now [turning their own partners against their client in court.](#)

If PwC was informed about Cassano's activities, then perhaps the SEC, the PCAOB and Department of Justice should finally turn their attention towards the audit firm. Maybe they can take a look at how [they played their two clients, AIG and Goldman Sachs, against each other](#) regarding the valuation of the same set of assets?

Why would either AIG or Goldman Sachs keep a firm like PwC around, one that adds no value, provides no guidance other than a nod of the head and turns on you to save their own skin when expedient? Well, it may be a prime example of the old adage, *"Keep your friends close and your enemies closer."* PwC knows where the bodies are buried and PwC has been

willing to go along with the program all these years. It's a pain in the neck to train a new auditor.

What's in it for PwC? \$205 million in fees from [AIG in 2009](#), an increase of 43% from 2008. PwC earned \$107 million from Goldman Sachs in 2009, an increase of 7% from 2008.

That sounds like \$312 million reasons for PwC to go along with the charade of independence.

With Cassano Off The Hook, Where Does PwC Hide In The AIG Case?

Jul 27th, 2010

Welcome to Episode 33 rpm of AIG and PwC and the Big Bad Wolf, Goldman Sachs. In this episode we attempt to slow things down and stop blaming our mother, I mean Goldman Sachs, for everything.

Let's consider for a moment the unnaturally close, preternatural relationship between AIG and PwC over the years. The dramas these two have been through together evoke the classic dysfunctional family, hell bent on destroying each other before they let anyone or anything destroy any of them...

“For decades,” [Gretchen Morgenson tells us](#) last Saturday in the New York Times, “Goldman and AIG had a long and fruitful relationship, with AIG insuring billions in mortgage-related securities that Goldman Sachs underwrote. When the mortgage market started to deteriorate in 2007, however, the relationship went sour...”

Goldman bought insurance against an AIG failure from large foreign and domestic banks, including [Credit Suisse](#) (\$310 million), [Morgan Stanley](#) (\$243 million) and [JPMorgan Chase](#) (\$216 million). Goldman also bought \$223 million in insurance on AIG from a variety of funds overseen by [Pimco](#), the money management firm.

Back in 2005, during an earlier scandal, reporters and plaintiffs like the [Ohio pension plans that recently settled with AIG and](#)

PwC for more than \$800 million, questioned PwC's independence from AIG:

The Washington Post, May 2005: "The relationship between PWC and AIG stretches back decades to when the firm still was called Coopers & Lybrand, before its 1998 merger with Price Waterhouse. Former AIG finance chief Howard I. Smith, who left the company earlier this year under pressure for failing to cooperate with regulators, spent almost two decades as an auditor at Coopers before joining AIG in 1984. Steven Bensinger, AIG's new chief financial officer, also started his career at Coopers & Lybrand.

In the lawsuit filed earlier this spring in U.S. District Court in Manhattan, Petro, the Ohio attorney general, alleges that PWC's independence was "impaired" by these long-standing ties and by nearly \$137 million in audit and consulting fees it received from AIG between 2000 and 2003."

They also didn't buy the excuses AIG made for PwC at the time – that PwC had been kept in the dark – and claimed there were enough red flags to pin some of the liability on the auditor.

"In a boost to PWC, AIG in its release this spring also explicitly told investors that auditors and board members had been kept in the dark by management about some AIG accounting maneuvers, including the company's dealings with Capco Reinsurance Co. Ltd., a Barbados reinsurance firm, and Union Excess Reinsurance Co. Ltd."

In the latest scandal at AIG, we've seen PwC and AIG's most senior executives such as former CEO Sullivan and CFO Bensinger attempt to divert attention from themselves. One example is the accusation against Joseph Cassano. Mr.

Cassano, albeit not the most likeable guy for numerous reasons, seems to have done everything he could to get it through the thick heads of PwC, Sullivan and Bensinger that there were wolves at AIG's door, even though [Cassano believes even now](#) that enough time and a suitably stubborn attitude could have fought them off.

[Everyone pointed at Cassano](#) as an obdurate, incorrigible, obfuscating guy at the root of all of AIG's problems.

[The Wall Street Journal, July 22, 2010](#): Joseph Cassano was once portrayed as a villain of our times.

Prosecutors... interviewed AIG senior management and the company's external auditor, and came away thinking Mr. Cassano hadn't properly disclosed multi-billion-dollar accounting changes that drastically cut the size of estimated losses, these people said...In interviews in 2008, Mr. Ryan told prosecutors he sometimes couldn't get straight answers from Mr. Cassano when he asked him to justify how AIG accounted for the swaps, these people said...Senior executives at AIG's parent company voiced similar misgivings to prosecutors a couple of years ago...However, Cassano was able to prove that he gave both PwC and Sullivan/Bensinger enough of a heads up to make their own decision what to tell investors in December.

{...}

The defense team rebutted the prosecution's allegations, presenting a version of events that portrayed Mr. Cassano as repeatedly disclosing bad news to his bosses, investors and PwC...its efforts helped focus prosecutors' attention on an obscure set of handwritten notes in their files, found scrawled

on the bottom of a printed spreadsheet...the annotations, which were made by a PwC partner at a meeting with Mr. Cassano and AIG management a week before the key December 2007 investor conference...Prosecutors realized the notes were disastrous to their case... Mr. Cassano had in fact disclosed the size of the accounting adjustments to both his bosses and external auditors.

It wasn't really news when the [Wall Street Journal](#) wrote about auditors' "scribbled notes that scuttled the AIG probe" and the [New York Times Deal Book](#) followed with a "me too" blurb the next day. We've known since [late May](#) that the Department of Justice no longer had a case against Cassano. He had apparently told the auditors and his bosses everything.

I wrote about Cassano's apparent transparency in [early April](#) and then again at the [end of June](#).

The investigations went south [when](#), "prosecutors found evidence Mr. Cassano did make key disclosures. They obtained notes written by a PwC auditor suggesting Mr. Cassano informed the auditor and senior AIG executives about the adjustment...[and] told AIG shareholders in November 2007 that AIG would have "more mark downs," meaning it would lower the value of its swaps." So who's telling the truth?

[Why are we seeing more stories now with more color commentary](#) on the Cassano vindication story? There have been a number of parallel investigations and inquiries occurring – criminal, civil and congressional – of the entire AIG/Goldman Sachs affair as well constant reminders of the financial crisis conundrums. As [Gretchen Morgenson](#) so aptly put it this past weekend:

“What did they know, and when did they know it?” Those are questions investigators invariably ask when trying to determine who’s responsible for an offense or a misdeed....a third, equally important question must be asked: “What did they do once they knew what they knew?”

All of these investigations are inevitably producing reams of information – lots of it in electronic form via emails and electronic records of conversations, meeting minutes, contracts and calculations. But this information is being made available to journalists and the general public on an intermittent and inconsistent basis. As the information dribbles out in linkable, source-able, quotable form, the journalists write more stories.

[Emails documenting internal conversations at AIG from 2007](#) were available to some journalists at the Washington Post as early as December of last year but were only recently posted to the [Financial Crisis Inquiry Commission’s \(FCIC\)](#) website for review by the general public.

The PwC documents proving Mr. Cassano’s contentions of good faith were probably available to the Department of Justice early this year. The substance of them was made available to some journalists in [April](#) when they started reporting Cassano would not face charges and then [later in May](#) when stories were written about charges being dropped. The actual documents show clearly that PwC knew everything in advance of the December 2007 AIG investor meeting. They were [recently posted](#) to the FCIC and [House Oversight Committee](#) sites.

The stories have been out there for a while. The details are now well known. AIG was under pressure from all sides since late 2006 and PwC stood side by side with them throughout:

- PwC, as AIG's auditor as well as Goldman Sach's auditor, was sitting smack dab in the middle of the valuation and fateful collateral dispute between the two firms;
- PwC and AIG senior executives bought time and diverted attention from themselves by allowing everyone and anyone including Cassano and Goldman Sachs to be blamed for AIG's failure;
- PwC knew AIG's recidivist nature very well, including how senior management had never really exerted sufficient control over individual managers like Cassano if they were making money for AIG;
- PwC's independence had been compromised repeatedly during their decades of service to AIG. They are part of the problem not the solution. PwC has been a defendant in multiple AIG lawsuits and continues to be named along side executives accused of fraud in new suits;
- PwC continued to enable AIG's "uncontrolled" ways even after the restatements and serious charges leveled for accounting manipulations and fraud of the 1999-2005 period. This potential professional negligence opened the door for Cassano and the Financial Products Group to construct the AIG super senior credit default swaps portfolio house of cards.

Every time a scandal such as this occurs, earnest journalists believe the auditors will come under closer scrutiny.

They don't.

“[American International Group Inc.](#)’s [admission this week](#) that it engaged in improper accounting practices is putting the nation’s largest independent auditing firm in the spotlight: PricewaterhouseCoopers LLP...For now, the Securities and Exchange Commission, which in February subpoenaed documents from the firm about AIG, isn’t focusing on the accountants’ actions, people familiar with the matter said. Instead, SEC investigators, working with New York state officials, are trying to determine what AIG told its auditors about deals under scrutiny and whether that information was truthful, the people said. But at some point, investigators will press PricewaterhouseCoopers to explain the reasons it missed the improper accounting, the people added.”

Instead, in this case, [PwC was reappointed](#) to their jobs with the help of enabler Arthur Levitt.

PwC, as auditor also of Goldman Sachs, JP Morgan, Bank of America, Barclays, Freddie Mac, PIMCO funds, and [two of the Big 3 ratings agencies](#) – Moody’s (until mid-2008) and Fitch – had a pretty good eye into both [AIG’s](#) and [Goldman Sachs’](#) counterparty risk and the ratings roller coaster ride they all were on.

From [Cassano’s FCIC testimony](#) in June 2010: “In light of the auditors’ heavy involvement in the fair-market-model evolution generally, and their **prior knowledge of the existence and magnitude of the negative-basis adjustment in particular**, I also found the material-weakness finding surprising, to say the least. I know AIG senior management argued strenuously against it.”

PwC, with KPMG, continues to allow their clients to delay asset markdowns, thereby only delaying inevitable losses to shareholders.

I asked Tucker Warren, spokesperson for the FCIC, when or if any of the audit firms – EY for Lehman, Deloitte for Bear Stearns, WaMu, American Home and Merrill Lynch, KPMG for Citigroup, Fannie Mae, Countrywide, Wachovia, and New Century or PwC for AIG, Freddie Mac, Goldman Sachs or Bank of America – would testify before the Commission on the causes of the financial crisis.

Mr. Warren told me that much of the Commission's work goes on behind the scenes, almost 7/8ths, like the proportion of a typical iceberg actually under the surface. Rest assured, he assured me, the Commission was receiving input from all relevant parties, whether we saw them testify during public hearings or not.

On the direct question of whether the audit firms had given private testimony Mr. Warren would not comment.

I asked Mr. Warren why the names of the PwC partners had been redacted in several of the documents recently posted to their site regarding AIG. After checking with the Commission's legal counsel, Mr. Warren told me that the individual auditors' names had been redacted because PwC had asked the Commission to obscure them.

Why, I asked Mr. Warren, would the Commission agree to such a request given the central nature of these individuals in the issues and conflicts that were being investigated? Why was the Commission giving PwC a pass on accountability for their role

in the AIG bailout and their epic collateral conflict with Goldman Sachs?

Mr. Warren responded that the Commission had considered PwC's request in light of whether redaction would change the truthfulness of the documents or inhibit the illumination of the issues that are their primary mandate. Would the Commission's mission be compromised by redacting information? The Commission also considered whether it was ***appropriate to subject "innocent" parties to public scrutiny if they were not central to the investigation.*** The decision was made that redaction would not harm the investigatory process.

I, of course, disagreed strongly and with [particularity](#) to Mr. Warren's popular misperception. We have evidence of apparent significant contradictions, of lies that seem to have been told regarding several aspects of the AIG investigation: PwC partners at the highest levels of the firm did hear Cassano's warnings early in their audit for 2007. They knew about Goldman Sachs' and other counterparties' increasing demands for more collateral given the widening spreads between AIG's and other's valuations. PwC knew AIG was out of synch with many of their counterparties as well as the overall market with regard to the valuation of the assets in question. They understood the potential for much bigger losses than anyone had previously anticipated. PwC made misleading statements to investigators. PwC did not push AIG hard enough or soon enough to disclose these risks in earlier 2007 and perhaps 2006 quarterly reports.

I can see the attempt by PwC to have their cake and eat it too. They initially claimed to have been [duped by AIG management](#)

including Cassano but now take credit as heroes for eventually forcing AIG to disclose a material weakness in the valuation process.

The key questions for PwC are:

- Why did PwC finally force AIG to disclose a material weakness in internal controls over their SSCDO valuation process in February after putting up with AIG's weaknesses, foibles, and subterfuge for so long?
- Who or what forced their hand and thereby forced AIG into an untenable negotiating position with other PwC clients such as Goldman Sachs and JP Morgan?
- Why had PwC tolerated incomplete and disingenuous disclosures by AIG in 2007 and prior regarding the widening philosophical and financial gaps between AIG and its trading partners?

Many journalists have hinted at the contradictions inherent in these as yet unanswered questions without perhaps appreciating the full import of the suggestion of fraud, professional negligence or, at least, malpractice.

Do plaintiffs' attorneys and their clients see these sins?

Will the SEC and Department of Justice finally conduct an investigation?

Will the Commissions and Committees of the US House and Senate finally call the auditors to account for their complicity in AIG and other financial firms' failures?

Isn't it about time to call a spade a spade?

Otherwise we must conclude that no one is guarding the guardians.

No one is acting as a watchdog for investors.

Seeking An Equitable Outcome: NY State Court of Appeals Hears In Pari Delicto Cases

Sep 13th, 2010

The New York State Court of Appeal will hear two cases, back to back, on Tuesday, September 14th that will have a direct and significant impact on auditors.

The *in pari delicto* defense prevents a plaintiff who is also at fault from recovering damages from a defendant.

“This scheduling by the courts is no coincidence. Two cases – one referred by a state Supreme Court, Delaware, the other by the 2nd Circuit Court of Appeals, a federal court – meant New York could no longer ignore the issue.” said Stuart Grant, in an interview this past weekend.

Grant is the attorney who will argue for the Teachers’ Retirement System of Louisiana and City of New Orleans Employees Retirement System in a case against PricewaterhouseCoopers LLP.

This is an [AIG Crisis One](#) case. According to comments from Grant & Eisenhofer on the case:

The auditor in this case – **PricewaterhouseCoopers** – is accused of failing to detect large-scale fraud at **AIG** related to alleged accounting manipulations and sham transactions that go back to 1999. PwC won dismissal of the suit in the trial court by arguing that because AIG employees committed the fraud that PwC failed to spot, AIG was “**in pari delicto**” with PwC (translation: at mutual fault) and therefore could not bring a claim.

Auditors have used similar defenses to avoid malpractice liability in a number of other cases, including a suit against **Grant Thornton LLP** by the bankruptcy trustee of **Refco, Inc.**, which will be addressed at the same September 14 hearing. This will mark the New York high court's first opportunity to decide whether New York law recognizes this defense as an outright bar to auditor malpractice liability. PwC knows well how high the stakes are, and has engaged former U.S. Solicitor General [Paul Clement](#) (now with King & Spalding) to plead its case.

Making the argument for investors is [Stuart Grant](#) of leading shareholder and corporate governance law firm **Grant & Eisenhofer**, who says the outcome of the hearing will have significant public policy ramifications. *“Corporations hire accounting firms and pay them huge fees to look for fraud by company employees. If an auditor can overlook fraud but escape malpractice liability by blaming the company for committing the fraud in the first place, then where is the accountability for the auditor? The company would have no recourse against the auditor, no matter how egregious the auditor’s conduct.”*

Kirschner v KPMG et al is the Refco case that is referenced above. This case also presents the possibility of an “*in pari delicto*” defense for audit firms. [Kathleen M. Sullivan](#) of Quinn Emanuel will argue the case for Kirschner, the Refco Trustee, before the court. The defendants – which include KPMG, Grant Thornton, PwC, and EY – are represented by [Philip D. Anker](#) (who represents Banc of America Securities) and [Linda T. Coberly](#) (who represents Grant Thornton) will argue before the Appeals Court on behalf of all the defendants.

[Law360.com December 23, 2009](#): “The trustee alleges outside counsel Mayer Brown, auditors [Ernst & Young](#) LLP, [PricewaterhouseCoopers](#) LLP, Banc of America Securities LLC and several other insiders are liable for defrauding Refco’s creditors, namely by helping the defunct brokerage conceal hundreds of millions of dollars in uncollectible debt.

The district court dismissed the trustee’s lawsuit in May for lack of standing, holding that the insiders’ alleged fraud and malpractice is directly imputed to Refco.

Now, the trustee contends the lower court erred in ascribing the insiders’ wrongdoing to Refco because the accused parties qualify for the “**adverse interest**” **exception to imputation**, having abandoned Refco’s interest in perpetrating the fraud. Specifically, the trustee maintains that the adverse interest exception should be applied because the insiders intended only to benefit themselves by their misconduct and that harm to Refco need not be alleged, according to the ruling...“*We conclude that the issues concerning imputation and adverse interest exception raise question of New York law as to which considerable uncertainty exists,*” the Second Circuit said. “*We therefore certify to the New York Court of Appeals questions the answer to which will govern our ultimate disposition of this appeal.*”

I wrote about both cases – *Kirschner v. KPMG LLP et al* and *Teachers’ Retirement System of Louisiana v. PricewaterhouseCoopers LLP* in a March 9, 2010 post, [In Pari Delicto: Are Auditors Equally At Fault In The Big Fraud Cases?](#)

The way I see it, the *in pari delicto* doctrine is being used like a pair of needle nosed pliers by audit firm defense lawyers to

diffuse a bomb – huge liability for some of the biggest frauds in history. The *in pari delicto* doctrine attempts to pull the auditors' tails from the fire by excusing any of their guilty acts due to the approval of those acts by potentially equally guilty executives. The law allows these executives to continue to “stand in the shoes” of the shareholder plaintiffs even after their guilt has been determined. The theory is that the executives perpetrated the fraud for the benefit of the corporation and never “totally abandoned” it, as would be required for the “adverse interest” exception.

Auditors who should otherwise be tested on their fulfillment of their public duty are instead getting a reprieve because courts have been unwilling to impose the [“adverse interest”](#) exception as expansively as they have the *in pari delicto* defense itself. How can executives who are successfully sued, been subject to regulatory sanctions or, in the case of the Refco executives, plead guilty to criminal activities, still be considered representatives of the corporation's interests? They should forfeit the right to stand in the shoes of the corporation's shareholders in derivative suits and therefore to shield other potentially guilty or negligent parties.

The situation gets complicated in a bankruptcy case such as Refco [because a] trustee in bankruptcy must have [standing](#) to sue anyone on behalf of the creditors and other injured parties. Unfortunately, this habit of allowing guilty parties to continue to drive the bankruptcy bus by having the [actions of the guilty officers “imputed” to the corporation](#) and, therefore, in bankruptcy to the trustee potentially threatens the trustee's ability to sue “co-conspirators.”

It's just nuts.

I was also quoted in [California Lawyer Magazine](#) regarding the auditors obligation to assess fraud risk and adjust their audit program accordingly.

“Auditing firms are supposed to be evaluating corporate governance, not just acting as bookkeepers. There are very thorough fraud risk checks under [Statement on Auditing Standards No.] 99 designed to spot red flags. This is very basic stuff, unrelated to the internal controls requirements of Sarbanes-Oxley.”

The [brief](#) prepared by Grant for the *Teachers’ Retirement System of Louisiana v. PricewaterhouseCoopers LLP* hearing on Tuesday afternoon is, in my opinion, spectacular.

To me the most interesting aspect of this case is that Grant argues right off the bat that an *in pari delicto* defense is not applicable to these facts. The *Teachers’ Retirement System* plaintiffs are not alleging the same wrongdoing by PwC as was alleged for the AIG executives. The plaintiffs, in a shareholders’ derivative claim that is brought on behalf of the corporation AIG, can not be found “equally at fault” if we are talking about different bad acts.

PwC’s sin is alleged to be accounting malpractice. The *Teachers’ Retirement System* plaintiffs allege PwC committed accounting malpractice because PwC performed such a miserable audit they didn’t even know the executives were committing the numerous examples of wrongdoing those executives were eventually held liable for.

Interestingly, the Vice Chancellor of the Delaware Court of Chancery told the *Teachers’ Retirement System of Louisiana* plaintiffs that if they had alleged instead that PwC

consciously aided and abetted wrongdoing by AIG insiders, the Court would've have had no problem hearing the case as a breach of fiduciary duty under Delaware state law.

As we know, the case could not be brought under federal securities laws since the [PSLRA bars private actions for aiding and abetting a fraud](#) and, Grant emphasized to me, [“Congress has not yet seen fit to amend this law to give private parties the same rights to hold third parties liable for fraud as the SEC has.”](#)

I know. I know.

From the [Brief for Appellants](#), *Teachers' Retirement System of Louisiana v. PricewaterhouseCoopers LLP*, page 23:

Moreover the defense only applies if the parties were also particeps criminis – i.e. partners in crime. In other words, it is not available unless the parties also served as co-conspirators or accomplices in the same alleged wrongdoing. This rule, which dispositively resolves the certified question, is longstanding and well-established under New York law. See Tracy, 14 N.Y. at 181.

Nailed it. How could the court come to any other conclusion?

Unfortunately, Grant's brief has to continue for forty-seven more pages because courts have not always seen the logic of separating the auditors from the executives of companies they audit. The audit firm defense lawyers have created a defense I call the, “We were duped!” defense that, to me, is an embarrassing, ridiculous and disingenuous attempt at evading liability.

The gist of it is: *“We did the best we could but as auditors we are dependent on management and their truthful representations to do a good audit. If they lie to us, what can we do? We are as much victims as the shareholders.”*

The *Teachers’ Retirement System v PwC* case is being closely watched by the accounting industry, says [The Financial Times](#). PwC is also a defendant in the *Kirschner v KPMG et al* (Refco) case. The American Institute of Certified Public Accountants, the New York State Society of CPAs and the [Center for Audit Quality](#) – all of them **non-independent trade groups that lobby for the audit industry** – have filed briefs supporting the accountancy firm’s arguments.

But let’s have the AICPA and the NYSSCPAs tell us in their own words, from their [amici brief](#) filed in support of PwC in the *Teachers’ Retirement System* case and of four audit firms – KPMG, Grant Thornton, PwC, And EY - in the Refco case:

*It is widely accepted that company management is in the best position, and has primary responsibility, to ensure the accuracy of its financial statements. See *Rift*, 834 P.2d at 762. Yet the Court’s acceptance of Appellants’ arguments would permit a company whose corporate culture likely incubated fraud (by, for example, tying management’s compensation to aggressive performance targets) **to shift responsibility for the resulting fraud to its outside auditors, who were in fact among its principal victims.**²⁵*

As discussed above, it would thus remove a key incentive for companies to police their own management. Paradoxically, then, the positions Appellants advocate as a way to promote accountability by auditors would reduce the accountability of

audit clients, those first in the line of defense against misconduct by management.

25 See, e.g., Michael R. Young, *Accounting Irregularities And Financial Fraud*, Chap. I (3d ed. 2006) (explaining that financial fraud typically begins with overly aggressive performance targets set by the board and/or management).

Michael Young is no stranger to defending the auditors. He's [one of their top skills](#). PwC is no stranger to the "We were duped," defense. PwC's former global chairman, [Sam DiPiazza, used it in reference to Satyam](#) while two of their partners sat in jail.

On the Satyam scam, DiPiazza said: "What we understand is that this was a massive fraud conducted by the (then) [management](#), and we are as much a victim as anyone. Our partners were clearly misled."

I'm sure PwC will throw *in pari delicto*, as well as every other old dirty legal shoe in the closet, at the New York courts re: Satyam to distract the judge from PwC's potential culpability.

Grant does a great job in his brief, also, of putting shareholders first when it comes to deciding matters of law with regard to auditors. He reminds the judges of the auditors' public duty. Grant cites the preeminent case that describes the role of an auditor above and beyond any financial arrangement facilitated by the audit committee on behalf of the firm's true client, the shareholders:

U.S. v Arthur Young & Co., 465 U.S. 805, 817-818 (1984)

*...By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. **The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public.** This "public watchdog" function demands that the accountant maintain total independence from the client at all times, and requires complete fidelity to the public trust. To insulate from disclosure a certified public accountant's interpretations of the client's financial statements would be to ignore the significance of the accountant's role as **a disinterested analyst charged with public obligations.***

When deciding whether auditors were fraudsters or just too dumb to see a fraud being perpetrated under their nose - neither excuse should be too attractive to a profession that gets paid for their independence, integrity and unique expertise - Grant believes the conclusion should not be drawn at the pleading stage. Auditors should have to prove to a jury who exactly "duped" them, how they were "duped", and to what extent they were truly "duped."

Maybe that's why the auditors [always settle](#). It's not that hard to swallow your pride and call yourself and your firm a stooge in a one-off preliminary court proceeding or a foreign newspaper. It's much more painful when you're forced to prove your incompetence conclusively in US open court.

Mr. Grant noted that there has never been a definitive ruling by the New York Court of Appeals on this issue. *“This case has huge implications for the auditing industry as well as shareholder derivative litigation,”* Mr. Grant said. *“What auditors are asking for is a ‘get-out-of-jail-free’ card that they can play every time their corporate client sues them for failing to detect fraud by a corporate manager. But detecting that kind of fraud is exactly what the client hired them to do. There needs to be some accountability. If they acted properly, let them have their day in court where they can prove it, but don’t foreclose the company from bringing the suit in the first place.”*

The [brief](#) prepared by the AICPA and NYSSCPAs uses [hyperbole, scare tactics and highly emotional language](#) about potential threats to the viability of the profession and the potential for higher fees or restricted access to services for companies if the questions are decided in favor of the appellants. It’s all in service to auditors and their business interests. There’s nothing about protecting shareholders. There’s nothing about the auditors’ public duty. It’s about protecting the status quo. The one that’s [worked so well for us leading up to the financial crisis](#).

“...auditors already have “a great deal of incentive to ensure accurate reporting,” and very little incentive to permit or assist management fraud. Baena, 453 F.3d at 9; see also In re Worlds of Wonder Sec. Litig., 35 F.3d 1407, 1427 n.7 (9th Cir. 1994) (“It is highly improbable that an accountant would risk surrendering a valuable reputation for honesty and careful work by participating in a fraud merely to obtain increased fees.”).”

Really?

Maybe they haven't seen the fees AIG pays PwC. [Suits that have since been settled against PwC and AIG](#) management claimed that, *"AIG's standing as one of PwC's biggest and most lucrative clients — it paid some \$136.6 million for services between 2000 and 2003 alone — compromised the close scrutiny the auditor was expected to exercise. "PwC's receipt of substantial audit and non-audit fees impaired its independence and objectivity."*

PwC is such a good buddy to AIG that they're still the auditors, in spite of being sued repeatedly by their client, AIG shareholders. For the 2008 fiscal year, a really tough one for AIG if you recall, [PwC charged AIG \\$131 million for just one year](#). I think that's starting to be the kind of money that makes most folks willingly abandon any independence and objectivity and live with being called "dupes" and "stooges." PwC's US firm, their New York office, the key partners on the engagement and the global firm overall would certainly feel the financial and emotional pain of losing AIG as a client.

The argument that slow and weak sanctions by the [SEC](#), even slower secret disciplinary proceedings by the [PCAOB](#), private causes of action against auditors neutered by the [PSLRA and by the Stoneridge decision](#), and the tendency of [some judges](#) to see the auditors as mere bookkeepers there to serve management will somehow act as a deterrent to auditor bad acts is naive at best and cruel at its worst.

The auditors and their excuses throw a sucker punch at the public investor when we can least afford another painful blow. We have a system where we can sue audit firms but we can not bring them to justice. I hope the New York State Court of

Appeals takes a long hard look at this perverse result and returns the law to the ideals of *U.S. v Arthur Young* (1984).

Addendum September 21, 2010: The law firm Orrick does a great job summarizing these two cases in the [Weekly Auditor Liability Bulletin](#) on September 17, 2010. They also have a link to all the briefs, including [all amicus curiae](#) briefs filed in both cases.

Top Ten Things Lawyers Should Know About Auditors

Sep 15th, 2010

In preparation for my appearance tonight at the New York County Lawyers Association program, [*A Crisis of Our Own Design*](#), I've put together some information about the accounting industry for lawyers.

Lawyers and auditors often work hand in hand. The modern corporation can't live with them but they, nevertheless, can't live without them. Executive compensation, mergers and acquisitions, taxes, financial disclosure... Accounting and the legal professionals weigh in, often together, sometimes in opposition, on decisions that affect all of us as investors, employees, vendors and customers.

Even though the largest global accounting firms are organized as partnerships – just like law firms – the similarities pretty much end there. Professional services is a unique industry – law, accounting, consulting, technology, executive search, even advertising have many common methods and madnesses. One of the primary differences between law and audit, the specialized service provided by accounting firms to a captive audience, is the client perspective.

[In the Matter of: CHARLES E. FALK, CPA...](#) The Commission's Codification of Financial Reporting Policies, which interprets Regulation S-X, prohibits members of accounting firms from acting as counsel to the firm's audit clients. Specifically, Section 602.02.e.i. of the Codification of Financial Reporting Policies states that "[c]ertain concurrent occupations of accountants engaged in the practice of public accounting involve

relationships with clients which may jeopardize the accountant's objectivity and, therefore, his independence Acting as counsel [is one of the] occupations so classified." Section 602.02.e.ii. of the Codification of Financial Reporting Policies explains that a "legal counsel enters into a personal relationship with a client and is primarily concerned with the personal rights and interests of such client. An independent accountant is precluded from such a relationship . . . because the role is inconsistent with the appearance of independence required of accountants in reporting to public investors."

*That prohibition is grounded in **the fundamental conflict that exists between the roles of independent auditor and attorney. Auditors have an obligation to the investing public to be skeptical about the information reported to them by their clients, which demands total independence from the client at all times. Attorneys, on the other hand, have a duty to serve as the client's confidential advisor and loyal advocate.***

The auditor's role is to be a gatekeeper. A watchdog. An advocate for the shareholders. Their true client is not the executive who contracts with them and pays the bill.

This is their public duty.

[*U.S. v Arthur Young & Co., 465 U.S. 805, 817-818 \(1984\)*](#)

*...By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. **The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders,***

*as well as to the investing public. This “public watchdog” function demands that the accountant maintain total independence from the client at all times, and requires complete fidelity to the public trust. To insulate from disclosure a certified public accountant’s interpretations of the client’s financial statements would be to ignore the significance of the accountant’s role as a **disinterested analyst charged with public obligations.***

This public obligation is mandated and subsidized by a government-sponsored franchise. All companies listed on major stock exchanges must have an audit opinion. Audit firms are meant to be shareholders’ first line of defense, and they are hired by and report to the independent Audit Committee of the Board of Directors not the company’s executives.

Today is the second anniversary of the Lehman Brothers bankruptcy. As such it is an honor to be on a panel tonight with [Anton Valukas](#), the Lehman Bankruptcy Examiner. It was his report that brought auditors, finally, into the discussion of the causes of the financial crisis. It was Valukas’ report that introduced “fraud” into the dissection of the financial crisis. My remarks tonight will touch on the now tenuous relationship between auditors/audits and identifying, mitigating, and preventing fraud.

Mr. Valukas highlighted several issues – colorable claims - where Lehman shareholders and society as a whole should hold Ernst & Young, Lehman’s auditors, liable.

There are two specific issues I’d like to highlight now, in preparation for our discussion tonight. I think they deserve more scrutiny and, potentially, the bright light of a trial.

First, there was an ongoing [contradiction between the accounting treatment \(a sale transaction\) and the disclosure \(a financing transaction\) of Repo 105 transactions](#) by Lehman. Ernst & Young, Lehman's long time auditors and designers of the Repo 105 strategy, knew the accounting treatment used was an aggressive interpretation of the accounting standards. The treatment was blessed by a UK law firm. However, financial statement disclosure by Lehman always characterized repurchase transactions as financing arrangements.

Auditors are [responsible for reviewing the interim financial statements](#), including the footnote disclosures every quarter end. Their job is to make sure, amongst other things, that disclosures match the accounting and are sufficient to support the public investors' right to transparency of financial information. The existence of a contradiction between Lehman's accounting treatment of Repo 105 transactions and a lack of matching disclosure of this treatment is supported by the examiner's report.

[Lehman Bankruptcy Examiner's Report](#), Volume 3, pages 1037-1038

Moreover, in addition to its duty to report a determination that there is evidence that fraud "may" have occurred, Ernst & Young was required to discuss with the Audit Committee the quality of Lehman's accounting principles as applied to financial reporting, see AU § 380.11, which would include moving \$30-\$50 billion temporarily off the balance sheet at quarter-end through overseas "true sale" legal opinions that could not be obtained in the United States. Indeed, AU Section 380.11 states that auditors should discuss accounting policies, unusual transactions, the clarity and completeness of the

financial statements, and unusual transactions with the audit committee.

Specifically, that standard states that an auditor:

should discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the entity's accounting principles as applied in its financial reporting. . . The discussion . . . should include such matters as the consistency of the entity's accounting policies and their application, and the clarity and completeness of the entity's financial statements, which include related disclosures. The discussion should also include items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements.

Secondly, another compelling negative for EY, in my opinion, is EY's claim in later public statements in response to the Lehman Bankruptcy Examiner's report of an [arbitrary cutoff for responsibility for the audit after the 2007 10K](#). Lehman remained an EY client, up to the bankruptcy in September 2008. This period included two more 10Qs.

Although the *Lattanzio* decision typically limits responsibility for auditor's opinions to only the annual report, this is because typically the quarterly reviews are done off line, with no written report or opinion included in 10Qs. (The Second Circuit reaffirmed in *Lattanzio v. Deloitte & Touche LLP* (Warnaco Sec. Litig.), 476 F.3d 147, 154-156 (2d Cir. 2007) that there's no auditor liability for alleged misstatements in *unaudited* quarterly financial statements.) However, in the Lehman case, and for many other financial firms, EY and the other large audit firms

consented to inclusion of signed *reports of their quarterly reviews* (as opposed to an *opinion* which has a very strict definition in the standards and the law) in the two 10Qs for 2008.

I think EY is vulnerable on this point.

So, without further ado...

“The Top Ten Facts Lawyers Should Know About Auditors”

A list à la David Letterman: the Top Ten facts that attorneys – regulators, legislators, judges, defense and plaintiffs’ bar – should know about the Big 4 global audit firms:

[Cue: Drumroll]

10. The Big 4 audit firms don’t bother looking for fraud. Why? First, it takes time and money to perform a [detailed fraud risk analysis](#) (SAS 99). But instead of supporting fraud risk analyses, in the post-SOX 404 environment, [CFOs are back to pressuring auditors](#) to reduce their fees and to do more for less —instead of more for more. Second, [senior management is almost always the source of fraud risk](#)—but that’s who audit firms see as their client because that’s who pays the bill. Who loses? Investors and the capitalist system. How else to explain Big 4 audit firms as auditors of all the major feeder hedge funds that poured billions into [Madoff’s fund](#) and yet none of them saw anything, heard anything or said anything about the numerous fraud red flags so obvious to anyone like Markopolous that looked?

9. The Big 4 firms aren’t comfortable being watchdogs. They don’t even like being CALLED watchdogs, in spite of a

[1984 Supreme Court decision](#) that reiterated their public duty. When an audit misses the really big frauds, the whoppers, their [first move is to evade responsibility](#). The Big 4 don't even like being called AUDITORS. Rather they provide "ASSURANCE Services, " and act as "TRUSTED ADVISORS". This isn't just rhetorical. It's a [cynical PR move](#) and an effort to limit their liability.

8. Big 4 firms should NEVER be asked to conduct internal investigations into alleged illegal activities for their audit clients. But companies continue to pull them into messy situations. A whistle-blower, allegations of illegalities or improprieties, concern about corruption in a business unit... An auditor may be part of the problem. That means embarrassing and costly lack of independence. (Read, ["E&Y at Lehman"](#) or ["KPMG at Siemens"](#)).

7. You know what Global Network means? It means shifting blame. The audit industry is a profitable \$100 billion revenue global business, employing hundreds of thousands of people. The ["Global Network"](#) is the legal vehicle the audit industry uses to drive liability around, in the Big 4 version of "Catch Me If You Can." Pick a legal entity to sue, any one, all of them and the Big 4 always win because they're behind the wheel. Each so-called "Member Firm" and the Global Network as a whole is legally insulated from the actions of any other "Member Firm." Even second-tier accounting firms use this tactic (read, ["Grant Thornton and Parmalat"](#)), but the bigger firms have it down to a (legal) science. They're members and partners until trouble hits. Then, sayonara! Can you say PwC and their problematic [Japanese](#) or [Russian](#) or [Indian](#) – firms?

6. The Big 4 will never again be indicted for an audit failure. Indicting Arthur Andersen proved one thing: All you have to do to destroy a big audit firm is make one criminal indictment. The SEC, the DOJ, even the PCAOB all have acknowledged that they can't afford the loss of another Big 4 audit firm. Why not? Because they don't have a plan for ensuring the integrity of financial information for investors if the current model falls apart. And in this environment, who's going to willingly wipe out 100,000 jobs? The audit firms hold a "Get Out Of Jail Free" card, and they know it. They don't fear being indicted. Individuals may be scapegoats (read, ["KPMG and their tax partners"](#) or ["Flanagan at Deloitte"](#)), but now the Big 4 have as much moral hazard as anyone. Unfortunately, the result is "assurance" provided by walking wounded – firms [so severely strained financially and strategically by billions of dollars of pending litigation](#) that their leaders spend most of their time addressing, evading or [settling claims](#) instead of improving audit quality.

6.a "Final Four" means no competition and no straight answers. Ask a Big 4 audit partner for a Yes/No answer on valuation, for example, and you won't get one. There's only four global firms remaining that have the depth and global breadth to serve the largest multinationals. [Each one is working for almost every bank](#) on Wall Street and in The City in some form or another. Independence rules make walking this line a highwire act. If not serving as auditor they're advising on M&A or internal audit, or internal controls. They may even be implementing new financial systems. For that reason, they're loathe to criticize anyone or anything and more often will play Switzerland, staying neutral as long as possible, like PwC did between [AIG and Goldman Sachs in one of the most notorious](#)

[disputes](#) of the financial crisis. Better, yet, just [keep them out of the loop](#) and everyone will be happy.

5. The auditors have a lock on the business (read, “ratings agencies”). Case in point? Ratings agencies. Both ratings agencies and audit firms have a governmental mandate to provide a legally required service. Both are paid by the clients they rate. And both repeatedly disappoint and even defraud the investing public. They aren’t in bed together, but they willingly endure [sleeping with the enemy](#).

4. Why do the auditors support IFRS and mark-to-market accounting? International Financial Reporting Standards (IFRS) are supposedly on the way for the US, the last big holdout. Forget GAAP’s rules-based guidance, where it’s easier to say an accounting treatment is right or wrong. Principles-based guidance leaves [wiggle room](#) and a pretty sure shot at sneaking liability caps for the auditors in through the back door. They’re looking for a “safe harbors” for exercising their “judgment.” And, of course, any [approach that causes confusion and complexity](#) is the “next big thing” driving large fees for the firms. Any questions?

3. Campaign candy from K Street. The Big 4 firms spread the wealth on both sides of the aisle in Washington, but the hands out always seem to be the ones with power to effect financial and regulatory reform. Does that reform ever go as far as it should? No. Should it have reached the audit firms at least this time? Absolutely. Did it? [No way](#).

2. Big 4 firms have systematically avoided liability for audit failures. Audit firms are comprised of individuals who become accountants because (a) it’s a path to slow and steady financial

success, (b) they've an affinity for details, and (c) they tend to be risk-averse. But they also work relatively autonomously, like a thousand franchise owners who are each expected to drive revenues and produce profits. So why are we shocked when (a) they are focused on fees and growing consulting services that make them rich, (b) they quietly but actively lobby for accounting rules that benefit their clients and laws that limit their accountability (read, [“PSLRA” and the “Stoneridge” decision](#), (c) they use accounting rules (read, “special purpose entities,” “off-balance-sheet agreements,” “deferred tax assets,” etc.) to help clients justify almost anything, and (d) they are very good at avoiding liability and painting themselves as [“victims”](#) when they “miss” fraudulent activity? Isn't this what they're being paid for?

1. AND THE #1 THING TO KNOW ABOUT ACCOUNTING FIRMS...

Lawyers are perceived as part of the problem. Most accounting industry professionals certainly don't see lawyers as part of the solution. The [SEC's Enforcement Division](#) is comprised principally of attorneys who formerly represented corporations. The audit firms are run by lawyers, internal and external, because they face a crush of litigation. Whether you serve them as defense or plaintiff's bar, your clients the accountants would rather do their work quietly, collect their money and not be bothered with you. Can regulatory organizations dominated by lawyers not trained in accounting standards or familiar with the history of audit failures, and who have never worked for an audit firm, themselves be watchdogs of the Big 4? Lawyers are trained to advocate *for* their clients; audit firms have forgotten who their clients really are – the

shareholders... Can lawyers influence auditors to do the right thing or has the accounting profession become too suit-shy? Do the SEC's lawyers have the right attitude to effectively "guard the guardians"?

New York Court of Appeals Stands By Corporate Man: In Pari Delicto Prevails

Oct 22nd, 2010

The [New York Court of Appeals decided](#) on October 21, 2010, by a vote of 4-3, to “*decline to alter our precedent relating to in pari delicto and imputation and the adverse interest exception, as we would have to do to bring about the expansion of third-party liability sought by plaintiffs here.*”

The decision is flawed, misguided and strongly biased towards corporate interests rather than shareholder and investor interests. [Imputation](#) – a fundamental principle that has outlived its usefulness and that defies common sense and fairness – has been reaffirmed in cases of third-party advisor negligence or collusion.

“A fraud that by its nature will benefit the corporation is not “adverse” to the corporation’s interests, even if it was actually motivated by the agent’s desire for personal gain (Price, 62 NY at 384). Thus, “[s]hould the ‘agent act[] both for himself and for the principal,’ . . . application of the [adverse interest] exception would be precluded” (Capital Wireless Corp. v Deloitte & Touche, 216 AD2d 663, 666 [3d Dept 1995] [quoting Matter of Crazy Eddie Sec. Litig., 802 F Supp 804, 817 (EDNY 1992)]; see also Center, 66 NY2d at 785 [the adverse interest exception “cannot be invoked merely because(the agent) is not acting primarily for his principal”]). [*12]

New York law thus articulates the adverse interest exception in a way that is consistent with fundamental principles of agency. To allow a corporation to avoid the consequences of corporate acts simply because an employee performed

them with his personal profit in mind would enable the corporation to disclaim, at its convenience, virtually every act its officers undertake. “[C]orporate officers, even in the most upright enterprises, can always be said, in some meaningful sense, to act for their own interests” (Grede v McGladrey & Pullen LLP, 421 BR 879, 886 [ND Ill 2008]). A corporate insider’s personal interests — as an officer, employee, or shareholder of the company — are often deliberately aligned with the corporation’s interests by way of, for example, stock options or bonuses, the value of which depends upon the corporation’s financial performance.

And this is ok?

A majority of the New York Court of Appeals bought the self-serving, selfish and unjust arguments of the defendants and their flunky amicus brief toadies supporting criminal corporate fraudsters and, *get this*, the shareholders of the accounting firms (!!). The New York Court of Appeals abandoned the shareholders and creditors of Refco and AIG for criminals and incompetents.

I could not have imagined more contemptible excuses for judicial cowardice if I were writing this decision for a novel of corporate cronyism to the extreme in a Utopian nirvana for capitalist parasites.

“In particular, why should the interests of innocent stakeholders of corporate fraudsters trump those of innocent stakeholders of the outside professionals who are the defendants in these cases?”

*...In a sense, plaintiffs' proposals may be viewed as creating a double standard whereby **the innocent stakeholders of the corporation's outside professionals are held responsible for the sins of their errant agents while the innocent stakeholders of the corporation itself are not charged with knowledge of their wrongdoing agents.** And, of course, the corporation's agents [*19] would almost invariably play the dominant role in the fraud and therefore would be more culpable than the outside professional's agents who allegedly aided and abetted the insiders or did not detect the fraud at all or soon enough. **The owners and creditors of KPMG and PwC may be said to be at least as "innocent" as Refco's unsecured creditors and AIG's stockholders.**"*

The doctrine's full name is *in pari delicto potior est conditio defendentis*, meaning "in a case of equal or mutual fault, the position of the [defending party] is the better one" (Baena, 453 F3d at 6 n 5 [internal quotation marks omitted]).

I have some other names for it:

- Immunity from **P**rosecution for the "**D**uped" theory
- Incompetent **P**rofessional service providers **D**efense
- Invocation of **P**lausible **D**eniability doctrine

"We are also not convinced that altering our precedent to expand remedies for these or similarly situated plaintiffs would produce a meaningful additional deterrent to professional misconduct or malpractice. The derivative plaintiffs caution against dealing accounting firms a "get-out-of-jail-free" card. But as any former partner at Arthur Andersen LLP — once one of the "Big Five" accounting firms — could attest, an outside professional (and especially an auditor)

*whose corporate client experiences a rapid or disastrous decline in fortune precipitated by insider fraud does not skate away unscathed. In short, outside professionals — underwriters, law firms and especially accounting firms — already are at risk for large settlements and judgments in the litigation that inevitably follows the collapse of an Enron, or a Worldcom or a Refco or an AIG-type scandal. Indeed, in the Refco securities fraud litigation, the IPO’s underwriters, including the three underwriter-defendants in this action, have agreed to settlements totaling \$53 million (www.refcosecuritieslitigation.com). In the AIG securities fraud litigation, PwC settled with shareholder-plaintiffs last year for \$97.5 million (www.refcosecuritieslitigationpwc.com). It is not evident that expanding the adverse interest exception or loosening imputation principles under New York law would result in any greater disincentive for professional malfeasance or negligence than already exists . Yet the approach advocated by the Litigation Trustee and the derivative plaintiffs would allow the creditors and shareholders of the company that employs miscreant agents to enjoy the benefit of their misconduct without suffering the harm. [*20]*

This argument comes directly from the [AICPA’s brief on behalf of the defendants](#) which all but threatened the capitalist system if audit firms were held accountable – including promises of higher audit fees if audit firms were forced to pay more settlements.

[I wrote](#) in March of this year:

“The *deepening insolvency* arguments have been [shot down](#) by no less than [Judge Posner](#) whose pernicious pragmatism

forces him to engage in the self-delusion that helping companies remain “viable” via fraud doesn’t hurt anyone. This fantasy presupposes the company to be a person and not the embodiment of the goals and objectives, hopes and dreams, faith and trust of the shareholders, employees, creditors, and community that count on it to continue legally and honorably instead. I suppose a [Supreme Court that allows corporations to donate money to political campaigns](#) in an exercise of their inalienable constitutional rights would not find this idea so strange.

When [Francis Pileggi sent me the update on the AIG case, Teachers’ Retirement System of Louisiana v. PricewaterhouseCoopers LLP](#), he asked me how I thought the New York Court of Appeals would rule. Given that there are two very similar cases facing the court on the in pari delicto doctrine, both with significant implications for future suits against auditors in fraud cases, I am hoping the justices consider the public interest carefully. If they do, I hope they will see that there is no public interest served in shielding additional guilty parties when a massive fraud is perpetrated against shareholders and other stakeholders.”

Are sufficient remedies [truly available to shareholders and investors](#) if the states abandon them, too?

As we know, the case could not be brought under federal securities laws since the PSLRA bars private actions for aiding and abetting a fraud. Stuart Grant, the attorney for the AIG shareholders, told me in September: *“[Congress has not yet seen fit to amend this law to give private parties the same rights to hold third parties liable for fraud as the SEC has.](#)”* Courts have not always seen the logic of separating the auditors from

the executives of companies they audit. The audit firm defense lawyers have created a defense I call the, “We were duped!” defense that, to me, is an embarrassing, ridiculous and disingenuous attempt at evading liability.

The gist of it is: *“We did the best we could but as auditors we are dependent on management and their truthful representations to do a good audit. If they lie to us, what can we do? We are as much victims as the shareholders.”*

In another example of roadblocks to private rights of action in fraud and accounting malpractice cases, an ancient former SEC Chairman recently joined others who have played “Charley McCarthy” to the audit industry’s “Edgar Bergen.”

Former [Chairman \[Rod\] Hills](#) also urged the SEC to create a safe harbor for an auditor’s professional judgment. He emphasized that a plaintiff should not have the right to question an auditor’s professional judgment if the SEC and the PCAOB are happy with that judgment.

[The last time I heard this one](#) – that auditors should not be held accountable to investors for their “judgment” – it was positioned as a necessity in the event the US adopted IFRS.

Made me nauseous.

In the UK, the Big 4 have even convinced [the “next tier” firms to beg for limitations on liability for the Big 4](#). GT and BDO must have given up on ever bulking up enough to compete with the Big 4. Maybe they’re jockeying for a buyout. Will we see more consolidation - allowing Big 4 firms to buy BDO and GT, for

example – rationalized by regulators as a way to insulate the industry from catastrophic claims?

Unfortunately, in the US, all of these concerns are addressed via the “too few to fail” policy – no large firm will be indicted by the federal government for criminal offenses, but civil penalties and sanctions will be meted out to culpable individuals only and only after many years of investigation when the story and the deterrent effect have been significantly diluted. Civil penalties against audit firms as a whole will be severely rationed. The private right of action against audit firms will be constrained by the PSLRA, the Stoneridge decision, obdurate judges, and archaic legal doctrines that perpetuate the “*we can be duped because we are simply humble bean counters and bookkeepers*” defense. Settling cases rather than going to trial means juries and the general public will never see “*how the sausage is made.*”

It’s shameful.

My only consolation for this huge disappointment – actually, I’m disgusted but some might claim I am *hysterical* in my condemnation of status quo perpetuation disguised as thoughtful judgment – is that three judges dissented.

Judge Ciparick dissents in an opinion in which Chief Judge Lippman and Judge Pigott concur:

“It is axiomatic that the adverse interest exception requires a showing of harm to the principal, but the premise that even an illusory benefit to a principal can serve to defeat the adverse interest exception to imputation misses the point. As the Second Circuit noted in CBI Holding, a “corporation is not a biological entity for which it can be presumed that any act

which extends its existence is beneficial to it” (529 F3d at 453, citing Bloor v Dansker, 523 F Supp 533, 541 [SD NY 1980]). Indeed, “prolonging a corporation’s existence in the face of ever increasing insolvency may be ‘doing no more than keeping the enterprise perched at the brink of disaster” (id., quoting Mirror Group Newspapers v Maxwell Newspapers, Inc., 164 BR 858, 869 [Bankr SD NY 1994]). As was borne out here, in the case of Refco, insider fraud that merely gives the corporation life longer than it would naturally have is not a true benefit to the corporation but can be considered a harm. The majority’s assertion that any corporate insider fraud that “enables the business to survive” defeats the adverse interest exception (majority op., at 19) would, as alleged here, condone the actions of the defendants...

*Moreover, in the corporate context where the fraud committed by corrupt insiders is either enabled by, joined in, or goes unnoticed by outside “gatekeeper” professionals, the use of these simple agency principles in such a manner has been rightfully criticized (see NCP Litigation Trust v KPMG LLP, 901 A2d 871, 879, 187 NJ 353, 366 [2006], quoting Morris, [*24]Clarifying the Imputation Doctrine: Charging Audit Clients with Responsibility for Unauthorized Audit Interference, 2001 Colum Bus L Rev 339, 353 [2001])...Indeed, these simplistic agency principles as applied by the majority serve to effectively immunize auditors and other outside professionals from liability wherever any corporate insider engages in fraud.*

Important policy concerns militate against the strict application of these agency principles. There can be little doubt that the role played by auditors and other gatekeepers serves the public as well as the corporations that contract for such services.

Investors rely heavily on information prepared by or approved by auditors, accountants, and other gatekeeper professionals. Corporate financial statements, examined by ostensibly independent auditors, “are one of the primary sources of information available to guide the decisions of the investing public” (United States v Arthur Young & Co., 465 US 805, 810-811 [1984]). It is, therefore, in the public’s best interest to maximize diligence and thwart malfeasance on the part of gatekeeper professionals (see generally Coffee, Jr., Gatekeeper Failure, 84 Boston U L Rev at 345-346 [“public policy must seek to minimize the perverse incentives that induce the gatekeeper not to investigate too closely”]; Shapiro, Who Pays the Auditor Calls the Tune?: Auditing Regulations and Clients’ Incentives, 35 Seton Hall L Rev 1029, 1034 [2005] [the purpose of audits is to “provide some independent assurance that those entrusted with resources are made accountable to those who have provided the resources”]).

Moreover, it is unclear how immunizing gatekeeper professionals, as the majority has effectively done, actually incentivizes corporate principals to better monitor insider agents. Indeed, it seems that strict imputation rules merely invite gatekeeper professionals “to neglect their duty to ferret out fraud by corporate insiders because even if they are negligent, there will be no damages assessed against them for their malfeasance” (Pritchard, O’Melveny Meyers v FDIC: Imputation of Fraud and Optimal Monitoring, 4 Sup Ct Econ Rev 179, 192 [1995]).

Thank you Judges Ciparick, Lippman and Pigott for your wisdom and common sense in disagreeing with this travesty.

Will Ernst & Young Ever Be Held Accountable for the Lehman Failure?

Oct 31st, 2010

I'd be exaggerating if I told you the [Lehman bankruptcy examiner's report](#), and its scathing indictment of Ernst & Young's role in the biggest failure on Wall Street, answered my prayers.

I pray for very little.

Peace of mind. Social justice. The health of family and friends. Increased scrutiny of the role of the largest global audit firms in the international financial markets.

They're modest entreaties but I sometimes wonder whether the gods are listening.

The [Lehman bankruptcy examiner's report](#), issued in March 2010, is a 2,000-word work of compelling non-fiction. [Anton Valukas](#), the examiner, gave us a model by which all future examination documents will be judged.

The report startled the media. Repo 105 – its creation and proliferation throughout the Lehman balance sheet – provided reporters, bloggers, pundits with something unexpected to write about. The inclusion of “colorable claims” against Lehman's auditors, Ernst & Young, drove renewed interest in the audit firms, their role and responsibilities to shareholders, and the history of their regulation.

Coverage of Ernst & Young (EY) by major media lasted, in earnest, about two months.

In April, [US media reported](#) the investigation of EY was “picking up steam”, based on sources pointing to an investigation by the PCAOB. Hot air. The PCAOB’s investigations are secret and it would be odd for them *not* to start some kind of an investigation under the circumstances.

There’s been nothing much new written about EY and the Lehman case since. There were a few stories right away about plaintiffs adding EY to their existing lawsuits. In June, the [UK’s Financial Reporting Council](#) (an accounting regulator) also initiated an investigation of EY’s Lehman activities. In September, they added [an investigation of EY’s reporting](#) to UK regulators regarding Lehman’s handling, or rather mishandling, of client assets.

Ernst & Young was mentioned briefly in early September in a ~700 word [Wall Street Journal](#) article on the ongoing SEC investigation of Lehman’s executives.

As part of its probe, the SEC is also investigating the role of Ernst & Young, Lehman’s outside auditing firm. The examiner concluded that Ernst & Young “took virtually no action to investigate the Repo 105 allegations.” A representative for [EY] declined to comment Thursday.

Lawyers for the former Lehman executives have previously denied any wrongdoing related to the accounting moves, while Ernst & Young said it complied with generally accepted accounting principles.

Ernst & Young, take my word for it, will never be indicted by the U.S. government, as a firm, for its role in any Lehman fraud that’s eventually proven. It’s also highly unlikely – 1000 to 1

odds I'd say – EY will be fined by the SEC or the [PCAOB](#), as a firm, in a civil or disciplinary case.

The Ernst & Young partners named in the bankruptcy examiner's report, and maybe a national practice partner, might be sanctioned by the PCAOB or SEC. Later. Much later. We can predict the timing based on the SEC's handling of the Bally's sanctions. Even with a slam dunk case, [the SEC waited six years](#) before they settled with EY. The eventual sanctions against six Ernst & Young partners for the Bally's fraud were too little and much too late to provide a deterrent or any real justice.

Ernst & Young, as a firm, and their individual partners are named as additional defendants in private lawsuits against Lehman executives. But the [New York Court of Appeals](#) in a 4-3 opinion refused to hold the [auditors responsible for their role in frauds perpetrated by management](#) in the Kirschner (Refco Trustee) v. KPMG and Teachers' Retirement v. PwC (re: AIG 2002-2005 fraud) cases. The opinion reaffirmed the application of the *in pari delicto* doctrine and the principle of *imputation* in these cases.

The judges who disagreed with the majority opinion said it best:

These simplistic agency principles as applied by the majority serve to effectively immunize auditors and other outside professionals from liability wherever any corporate insider engages in fraud...it is unclear how immunizing gatekeeper professionals, as the majority has effectively done, actually incentivizes corporate principals to better monitor insider agents. Indeed, it seems that strict imputation rules merely invite gatekeeper professionals "to neglect their

duty to ferret out fraud by corporate insiders because even if they are negligent, there will be no damages assessed against them for their malfeasance”

The more successful a fraud case is against Lehman’s executives, the less likely EY or any of its partners will suffer any consequences for their acquiescence to or complicity in the fraud. That’s not to say the firm won’t suffer slowly and painfully from the enormous amount of time and money devoted to defending themselves in Lehman litigation and the rest of the suits they face. And, of course, there is reputational damage with some clients. That’s why their Chairman has gone on the [PR defensive](#).

But with regard to Lehman cases, EY can now take a breath. When executives commit fraud and are held liable, and especially when there’s a bankruptcy involved, auditors are rarely held responsible.

The judges make it almost impossible.

The majority of the New York Court of Appeals feels we should be as sympathetic to the partners of the poor “duped” accounting firms as we are to the creditors and shareholders of the companies, Refco and AIG, whose executives stole from them.

... plaintiffs’ proposals may be viewed as creating a double standard whereby the innocent stakeholders of the corporation’s outside professionals are held responsible for the sins of their errant agents while the innocent stakeholders of the corporation itself are not charged with knowledge of their wrongdoing agents... The owners and creditors of KPMG and

PwC may be said to be at least as “innocent” as Refco’s unsecured creditors and AIG’s stockholders.

That leaves [few avenues of recourse for the shareholders and creditors against the aiding and abetting service providers](#). If only the Department of Justice and the SEC, followed closely by the PCAOB, led the way in calling the audit firms to account for their professional impotence and the occasional deliberate legal deviance.

But the regulators will disappoint me.

Why?

The U.S. government needs Ernst & Young more than it needs me.

From The Congressional Oversight Panel Report, [Examining Treasury’s Use of Financial Crisis Contracting Authority](#):

Ernst & Young has the largest amount of expended value attributable to its work. Ernst & Young has performed work as a contractor under a procurement contract as well as a subcontractor under financial agency agreements. Of the \$32.2 million in expended value attributable to Ernst & Young, \$10.7 million is related to a procurement contract for accounting services, and \$21.5 million is related to subcontracts under financial agency agreements, \$17.7 million of which was expended under a contract with Freddie Mac and the remaining \$3.8 million was expended under a subcontract with Fannie Mae. In addition, Ernst & Young has been granted the same \$22 million multiple awards as PricewaterhouseCoopers.

Well, you might say, those contracts were handed out at the peak of the crisis, September 2008. [What could the U.S. Treasury do?](#) There are only four large accounting firms that could possibly get the tough job done.

PricewaterhouseCoopers – auditor of Goldman Sachs, AIG, JP Morgan Chase, Bank of America, the twelve Federal Home Loan Banks and Freddie Mac – is the largest contractor to the Treasury under the financial crisis contracting authority. KPMG is the Treasury’s own auditor and was preoccupied with auditing failed [New Century and Countrywide](#), getting sued by former client Fannie Mae, and trying to hold on to troubled Citigroup, Wells Fargo and Wachovia. What were Deloitte’s conflicts? Deloitte was busy with its own problems as auditor for Bear Stearns, Washington Mutual, Merrill Lynch, GM, and Fannie Mae as well as auditor of the Federal Reserve Bank system, itself.

However, in a slap in the face to Lehman employees and shareholders all over the world and to the U.S. taxpayer who’s paying the bill, Ernst & Young was awarded *another contract by the U.S. Treasury in July of 2010*, two years after the crisis and *only three months after the Lehman bankruptcy examiner’s report* was published. This contract, [a blanket purchase contract](#) for *Program Compliance Support Services* effective until July 2015, is essentially a blank check.

In addition to the contracts with the U.S. Treasury, Ernst & Young – along with Deloitte and PricewaterhouseCoopers - is a key vendor at the [New York Federal Reserve Bank](#).

From the New York Federal Reserve Bank [Vendor Information](#) page:

Maiden Lane LLC (re: Bear Stearns)

MAIDEN LANE LLC (ML LLC), MAIDEN LANE II LLC (ML II), MAIDEN LANE III LLC (ML III) (AS INDICATED BELOW)	
VENDOR	DESCRIPTION
BlackRock Financial Management, Inc. (BlackRock) (3 contracts)	Investment management and advisory services for ML LLC, ML II & ML III
Ernst & Young LLP (E&Y) (1 contract)	Closing work for ML LLC (see note ² below); Note that E&Y performed closing work for ML II & ML III pursuant to a contract related to the AIG matter, which is linked below.
Deloitte & Touche LLP² (3 contracts)	Audit services for ML LLC, ML II & ML III
State Street Bank & Trust Company (2 contracts and 1 fee letter)	Administrative and custodial services for ML LLC
Bank Of New York Mellon (BNY Mellon) (2 contracts and 1 fee letter)	Administrative and custodial services for ML II and ML III

Note: Fees for the above vendors are paid by ML LLC, ML II, or ML III.

² Although the detailed description of the scope of work set forth in this contract has been redacted due to confidentiality concerns, a general description of the scope of work is as follows: E&Y was contracted to perform due diligence on the assets in the Maiden Lane LLC portfolio to assess and evaluate the quality and accuracy of financial information provided by Bear Stearns & Co. and obtained from external sources prior to acquisition by the LLC. E&Y identified all cashflows from the determination date through the closing date to facilitate settlement of the assets into the LLC. E&Y tracked and verified post close cash flow adjustments with the Investment Manager.

TALF

TERM ASSET-BACKED SECURITIES LOAN FACILITY (TALF)	
VENDOR	DESCRIPTION
BNY Mellon (2 contracts and 1 fee letter)	Administrative and custodial services
Ernst & Young LLP	NOTE: E&Y performed accounting consulting services for TALF pursuant to a contract related to the AIG matter, linked below.
McKinsey & Company (1 contract)	Consulting services
BlackRock Financial Management, Inc. (1 contract)	Collateral monitoring services
PIMCO (1 contract)	Collateral monitoring services
Trepp, LLC (1 contract)	Collateral monitoring services

AIG Lending Arrangement

AIG LENDING ARRANGEMENT	
VENDOR	DESCRIPTION
Ernst & Young LLP (1 contract)	Advisory services (see note ⁴ below) ; Note that pursuant to this contract, E&Y also provided services with respect to ML LLC, ML II, ML III, TALF, in addition to its services related to AIG.
Houlihan Lokey (4 engagement letters)	Advisory Services
Morgan Stanley (2 contracts)	Advisory services; Note: Pursuant to this contract, work was also performed for ML II and ML III.
Note: While the Bank initially pays the fees and costs related to the above vendors, those fees and costs are subsequently reimbursed by AIG. Certain expenses under the E&Y contract were paid by ML LCC, ML II, ML III and TALF LLC.	

4 Although the detailed description of the scope of work set forth in this contract has been redacted due to confidentiality concerns, a general description of the scope of work is as follows:

With respect to AIG, E&Y was contracted to provide advice on the insurance businesses; to perform valuations of the entities posted as collateral; to provide assistance in developing cash flow projections; to provide support for the divestiture process; to provide advice and assistance with domestic and global regulatory issues; to identify and report on compliance with covenants within the Credit Agreement; to provide assistance in assessing accounting and tax considerations, including off-balance sheet arrangements; to provide project management support; to provide advice and assistance on compensation issues; to provide assistance and support in assessing internal audit at the firm; to provide advice and due diligence on contemplated transactions, including SPVs and securitizations; to develop a document repository; and to provide advice and assistance in monitoring business unit performance within AIG.

With respect to ML LLC, ML II, ML III, E&Y was contracted to perform a diagnostic on the operational and financial close procedures, and to assist with the analysis of accounting matters. In addition, with respect to ML II, E&Y was contracted to perform due diligence on the assets to assess and evaluate the quality and accuracy of financial information provided by AIG and obtained from external sources prior to inclusion in the trust. E&Y identified all cashflows from the pricing date through the closing date to facilitate settlement of the assets into the LLC. E&Y tracks and verifies with the administrator all post close factor changes through August 31, 2009. With respect to ML III, E&Y was contracted to perform due diligence on the assets to assess and evaluate the quality and accuracy of financial information provided by AIGFP and obtained from external sources prior to inclusion in the trust. E&Y identified all cashflows from the pricing date through the closing date to facilitate settlement of the assets into the LLC. E&Y tracks and verifies with the administrator all post close factor changes through August 31, 2009. With respect to TALF, E&Y assisted with accounting procedures and the analysis of accounting matters.

Even I have to admit that this work makes EY pretty indispensable.

And, therefore, immune from prosecution.

But don't take my word for it.

On October 14, the Congressional Oversight Panel (COP) issued its monthly oversight report, [“Examining Treasury’s Use of Financial Crisis Contracting Authority”](#). The report highlights many of the issues raised in testimony by the [Project on Government Oversight \(POGO\)](#) and in their letter to Congress.

The Panel highlighted two big reasons why the U.S. Treasury and, by extension, their subordinate agencies [the SEC and PCAOB](#) and sister department Justice won't jeopardize the viability of vendors they're counting on the most to support them during these very trying times.

a. Future Industry Regulation

Acting in its regulatory capacity, Treasury may need to regulate a business that it is also employing to do work. It is hard to see how Treasury could avoid the perception of a conflict of interest if it implements industry-specific regulations or regulates an individual business, and such oversight could have direct implications for the ability of a contractor or financial agent to perform...It is also possible that a firm could attempt to leverage its relationship with Treasury to enhance its capacity to lobby effectively with other regulators... particularly relevant in the wake of Dodd-Frank Wall Street Reform...

You may have noticed that the audit industry was [pretty much left out of the Dodd-Frank reform bill](#), even as the bill destroyed

the business model of the ratings agencies. The ratings agencies, as you know, operate under the same direct-pay business model that compromises the independence and objectivity of the audit firms. The SEC also quickly enacted additional safeguards after the Supreme Court reaffirmed the viability of the PCAOB under the Sarbanes-Oxley Act. These “safeguards” provide an appeals process for audit firms that feel victimized by the [PCAOB’s “arbitrary and capricious” disciplinary actions](#).

c. Overreliance on Individual Firms

*Ensuring that contracts and agreements are awarded to a broad group of firms may be critical to minimizing conflicts of interest. Awarding a large number or value of contracts or agreements to one specific firm may leave Treasury overly reliant on that particular institution. Such overreliance may cause Treasury to be disproportionately dependent on certain firms or industries...Forcing senior Treasury officials into the simultaneous role of regulator and client may place them in an awkward position. Likewise **Treasury may be hesitant to implement certain types of accounting reforms when it has an outstanding contract of \$24.6 million with PricewaterhouseCoopers (pwc), particularly when such reforms would subject the investment of taxpayers funds to more risk.***

Translated, that means don’t count on the Department of Justice or the SEC to question pwc’s role in the [Satyam or Glitnir frauds](#), to pressure pwc to resign as auditor of AIG even though their true client, AIG shareholders, has sued them repeatedly, or to answer for their duplicity with regard to

allowing widely different valuations of the same assets at [Goldman Sachs and AIG](#).

Big 4 Bombshell: “We Didn’t Fail Banks Because They Were Getting A Bailout”

Nov 28th, 2010

Leaders of the four largest global accounting firms – [Ian Powell](#), chairman of PwC UK, [John Connolly](#), Senior Partner and Chief Executive of Deloitte’s UK firm and Global MD of its international firm, [John Griffith-Jones](#), Chairman of KPMG’s Europe, Middle East and Africa region and Chairman of KPMG UK, and [Scott Halliday](#), UK & Ireland Managing Partner for Ernst & Young – appeared before the UK’s House of Lords Economic Affairs Committee yesterday to discuss competition and their role in the financial crisis.

The discussion moved past the topic of competition when the [same old recommendations were raised and the same old excuses](#) for the status quo were given.

[Reuters, November 23, 2010](#): The House of Lords committee was taking evidence on concentration in the auditing market and the role of auditors.

Nearly all the world’s blue chip companies are audited by the Big Four, creating [concerns among policymakers of growing systemic risks](#), particularly if one of them fails.

“I don’t see that is on the horizon at all,” Connolly said.

The European Union’s executive European Commission has also opened a public consultation into ways to boost competition in the sector, such as by having smaller firms working jointly with one of the Big Four so there is a “substitute on the bench.”

“Having a single auditor results in the best communication with the board and with management and results in the highest quality audit,” said Scott Halliday, an E&Y managing partner.

The Lord’s Committee was more interested in questioning the auditors about the issue of “going concern” opinions and, in particular, why there were none for the banks that failed, were bailed out, or were nationalized.

The answer the Lord’s received was, in one word, “Astonishing!”

Accountancy Age, November 23, 2010: *Debate focused on the use of “going concern” guidance, issued by auditors if they believe a company will survive the next year. **Auditors said they did not change their going concern guidance because they were told the government would bail out the banks.***

“Going concern [means] that a business can pay its debts as they fall due. You meant something quite different, you meant that the government would dip into its pockets and give the company money and then it can pay its debts and you gave an unqualified report on that basis,” Lipsey said.

Lord Lawson said there was a “threat to solvency” for UK banks which was not reflected in the auditors’ reports.

“I find that absolutely astonishing, absolutely astonishing. It seems to me that you are saying that you noticed they were on very thin ice but you were completely relaxed about it because you knew there would be support, in other words, the taxpayer would support them,” he said.

The leadership of the Big 4 audit firms in the UK has admitted that **they did not issue “going concern” opinions because**

they were told by government officials, confidentially, that the banks would be bailed out.

The Herald of Scotland, November 24, 2010: John Connolly, chief executive of Deloitte auditor to Royal Bank of Scotland, said the UK's big four accountancy firms initiated "detailed discussions" with then City minister Lord Paul Myners in late 2008 soon after the collapse of Lehman Brothers prompted money markets to gum up.

Ian Powell, chairman of PricewaterhouseCoopers, said there had been talks the previous year.

Debate centred on whether the banks' accounts could be signed off as "going concerns". All banks got a clean bill of health even though they ended up needing vast amounts of taxpayer support.

Mr. Connolly said: "In the circumstances we were in, it was recognised that the banks would only be 'going concerns' if there was support forthcoming."

"The consequences of reaching the conclusion that a bank was actually going to go belly up were huge." John Connolly, Deloitte

He said that the firms held meetings in December 2008 and January 2009 with Lord Myners, a former director of NatWest who was appointed Financial Services Secretary to the Treasury in October 2008.

I've asked the question many times why there were no "going concern" opinions for the banks and other institutions that were bailed out, failed or essentially nationalized here in the US. I've never received a good answer until now. In fact, I had the

impression [the auditors were not there](#). There has been no mention of their presence or their role in any accounts of the crisis. There has been no similar admission that meetings in took place between the auditors and the Federal Reserve or the Treasury leading to Lehman's failure and afterwards. No one has asked them.

How could I been so naive?

If it happened in the UK, why not in the US?

Does [Andrew Ross Sorkin](#) have any notes about this that didn't make it to his book?

Will [Ted Kaufman](#) call the auditors to account now that he is Chairman of the Congressional Oversight Panel?

Is there still time to call the four US leaders to testify in front of the [Financial Crisis Inquiry Commission](#)?

What is the recourse for shareholders and other stakeholders who lost everything if the government was the one who prevented them from hearing any warning?

Certainly the auditors are now more inside the room than outside. I never take them for toadies, just standing in the corner waiting for their orders after the big boys talk, even though others have said [I give them too much credit](#) for being strategic. Their complacency is calculated. [They are much too tied into the work, and the millions in fees, that have been generated by the aftermath of the crisis.](#) Are the millions in fees for supporting the Treasury and the Fed's cleanup of the crisis their reward for going along? Is this the same acquiescence that doesn't seem to bother their UK colleagues one bit?

Reuters: John Griffith-Jones, chairman of KPMG in Europe, said the banking industry is built on confidence and that full disclosure is absolutely fine in a stable environment.

“Come a crisis, the government of the day and Bank of England of the day may prefer the public not to know... to control events in those circumstances,” Griffith-Jones said.

And so the government has controlled information about the auditors’ role in the US.

No one knows whether similar meetings were held between audit leadership and the Federal Reserve Bank and US Treasury. No one has asked them to testify before a Congressional Committee. When their presence in meetings at Goldman Sachs and AIG, for example, was exposed via emails and correspondence subpoenaed by Congressional investigators, [the names were redacted at their request.](#)

Contracts with the Treasury and the New York Federal Reserve Bank are similarly redacted. We can’t trace whether the audit firm professionals working for the government now are the same ones working for their clients who failed. We can’t check that those who looked the other way when balance sheets were manipulated and assets valued unrealistically are the same ones now advising how to optimize the value of those same assets for the taxpayer. We are unable to verify if the same partners who failed us at the banks, at AIG, at Lehman, and at Bear Stearns are now managing their assets for the taxpayer.



You can listen to the Big 4 testimony before the House of Lords [here](#). There is much more to it and I will report on the rest at a later date. A full transcript will be available [here](#) by early next week.

Photo left to right: Scott Halliday (EY), Ian Powell (PwC), John Griffith-Jones (KPMG), John Connolly (Deloitte)

No Bark, No Bite: PricewaterhouseCoopers Rolls Over To Beat Fraud Cases

Dec. 30 2010



Image via Wikipedia

When I was a boy in Glasgow, we had a little Scottish terrier.

Ginger didn't bark. Ginger didn't bite.

Ginger snapped.

-One of my father's favorite stories

If the watchdogs had at least snapped, we'd all be a lot better off.

We're waiting patiently for the Delaware Supreme Court to decide an old case against PricewaterhouseCoopers (PwC) involving several AIG executives, their alleged third-party co-conspirators and more than one fraud.

AIG shareholders returned to Delaware's Supreme Court on December 15th to pursue claims against [General Re Corp.](#), insurer [ACE Ltd.](#), insurance broker [Marsh & McLennan Cos.](#) and PricewaterhouseCoopers (PwC) over an alleged bid-rigging scheme involving insurance contracts. The dismissal of claims against the third-party conspirators was affirmed in [an opinion](#) published yesterday.

According to reports of the oral arguments from [Bloomberg](#):

Stuart Grant, attorney for the plaintiffs, told the court that, “upholding the lower court ruling would allow wrongdoers to “get away scot-free.” He said their job was “to make sure damages lie where the fault lies.”

Allowing investor suits against auditors in such fraud cases would provide “some level of accountability” for accounting firms, Grant noted.

In spite of a [recent opinion by the New York State Court of Appeals](#) in the AIG shareholders’ case against PwC, Grant argued PwC should also be held accountable for missing the scheme.

PwC’s audit client – the AIG shareholders – asked the court to hold PwC responsible for missing a scheme that’s cost them more than \$2.3 billion in settlements since 2006. But PwC’s attorney, [Thomas Rafferty](#), said the firm and its partners shouldn’t be blamed because the alleged “bad guys” tried to hide their bad actions from PwC. (This is even though [PwC settled for \\$97.5 million](#) with the Ohio Public Employees Retirement System in a related case.)

“We had auditors in this case who were hoodwinked by their client,” [he said](#). Investors are asking for the right to sue accountants “because their client fooled them.”

I listened to the [oral arguments](#). I may disagree with the points made by attorney Thomas Rafferty, but he argued his case for PwC better and more strenuously. However, shareholders who may bring claims against auditors in New York in the future –

and the Delaware Supreme Court judges – should heed Mr. Grant’s conclusion:

“If you’re a New York corporation an audit is worthless. Under this doctrine, there is no accountability for auditor negligence.”

PwC has played the “dupe card” more than once, most notably in [defending itself](#) against claims its own partners in India – who ended up in an Indian jail – allegedly aided and abetted the \$1 billion fraud at Satyam. PwC also claimed they were lied to by audit client Yukos for ten years. In 2007, PwC withdrew all audit opinions from 1994-2003 for the Russian oil company. [PwC’s move in the Yukos case](#) has been repeatedly attributed in media reports, and by US diplomats in [cables released by Wikileaks](#), as potentially the result of coercion by the Russian government.

[Joe Nocera in the New York Times](#), November 6, 2010: For several years, Pricewaterhouse held firm. But according to Mr. Khodorkovsky’s supporters, the pressure eventually became too much for the firm’s executives to bear. In June 2007, the accounting firm withdrew its support for the audits it had once conducted with such pride. Soon thereafter the prosecutors brought their case.

Pricewaterhouse adamantly insists that it did not fold under pressure. The prosecutors, the firm claims, uncovered “new information” that made it impossible for the company to stand by its audits. In a statement, the firm said that this information suggested “that Yukos’s former management may have made inaccurate representations to PwC during the course of PwC’s

audits.” A spokesman told me the firm’s professional standards gave it no choice but to turn its back on its audits.

In this AIG case, the original June 17, 2009 opinion of the Delaware Court of Chancery affirmed a Motion to Dismiss against PwC based on a prior ruling in [February of 2009](#). That ruling said New York law applied to the case and that New York’s approach to the legal doctrine of [in pari delicto](#) barred AIG from recovering against PwC.

The shareholders appealed the decision regarding PwC to the [Delaware Supreme Court](#). In an unusual move, Delaware asked the New York Court of Appeals to give their opinion on the in pari delicto issue, which was controlled by New York law. In reply, New York’s highest court explained New York law regarding in pari delicto as it applied to this case.

The [New York Court of Appeals decided](#) on October 21, 2010, by a vote of 4-3, to “decline to alter our precedent relating to in pari delicto, and imputation and the adverse interest exception, as we would have to do to bring about the expansion of third-party liability sought by plaintiffs here.”

That’s why the AIG shareholders were back in the Delaware Supreme Court last week for a final shot at justice. Instead, Delaware may be obligated to follow New York law with regard to PwC. The decision by the New York Court of Appeals was, I believe, flawed, based on obsolete principles, and strongly biased towards corporate interests rather than shareholder and investor interests.

The AIG shareholders may lose their case against PwC. But, more importantly, if the Delaware Supreme Court affirms the

Motion to Dismiss against PwC too, shareholders will probably lose against auditors in New York in any case where a company's executives are found to have committed fraud if they didn't completely abandon the company's interests while pursuing that fraud. (Complaints in the [Refco fraud case](#) against several audit firms, including PwC, have [already been dismissed](#) as a result of this decision.)

The majority judges on the New York Court of Appeals judges mimicked the [amici briefs](#) filed by the AICPA and several other usual suspects in their opinion in October. Fortunately, there were three strong dissenters. Judge Ciparick states:

It is unclear how immunizing gatekeeper professionals, as the majority has effectively done, actually incentivizes corporate principals to better monitor insider agents. Indeed, it seems that strict imputation rules merely invite gatekeeper professionals "to neglect their duty to ferret out fraud by corporate insiders because even if they are negligent, there will be no damages assessed against them for their malfeasance"

If Ernst & Young is looking for [a defense against the New York Attorney General's lawsuit](#) in the Lehman failure, maybe playing dumb is their best bet. Auditor incompetence is no longer considered negligence or malpractice in New York.

Duped. Hoodwinked. Victim. Fooled. Deceived. Misled.

That's not a watchdog. That's a lapdog.

PwC Prevails In Decision On AIG “In Pari Delicto” Case

Jan 6th, 2011

The Supreme Court of the State of Delaware issued an [opinion](#) on January 3rd, 2011 affirming the dismissal of claims against PricewaterhouseCoopers (PwC) in the Teachers Retirement System of Louisiana derivative suit. This suit, as described further below, relates to an earlier fraud case at AIG.

*...The New York Court of Appeals accepted the certified question, and issued an opinion holding that the in pari delicto doctrine would bar such a derivative claim.*³

4) In their supplemental briefing, Derivative Plaintiffs argued that the Kirschner decision is not binding on the issue of imputation of wrongdoing, which, they claim, is a question of Delaware law.

5) We reject this argument for two reasons. First, Derivative Plaintiffs acknowledged in their Opening Brief that, under the facts of this case, imputation is a question of New York law. Second, in our certification request, this Court sought resolution of a “determinative question[] of New York law”⁴

The Kirschner decision provided a determinative answer, which this Court must follow....

1A.I.G., Inc. v. Greenberg, 965 A.2d 763 (Del. Ch. 2009).

2Teachers’ Retirement System of Louisiana v. PricewaterhouseCoopers LLP, 998 A.2d 280, 282-3

(Del. 2010).

3 *Kirschner v. KPMG LLP et al.*, 2010 WL 4116609 at *14 (N.Y.).

A PwC spokesperson provided this comment on the decision to me:

“In affirming the dismissal of these claims, the Delaware Supreme Court followed the definitive statement of law already issued by New York’s highest court. In October, the New York court rejected calls to alter 200 years of legal precedent to bring about the expansion of third-party liability sought by derivative plaintiffs. The Delaware Supreme Court considered that advice and affirmed the dismissal of the derivative claims.”

As I predicted in [my post at Forbes on December 30th](#), PwC prevailed because the Delaware Supreme Court had little choice but to follow New York’s direction regarding *in pari delicto*, barring a strong argument otherwise from the plaintiffs. Stuart Grant, attorney for the plaintiffs, did not make one.

AIG shareholders returned to Delaware’s Supreme Court on December 15th to pursue claims against [General Re Corp.](#), insurer [ACE Ltd.](#), insurance broker [Marsh & McLennan Cos.](#) and PricewaterhouseCoopers (PwC) over an alleged bid-rigging scheme involving insurance contracts. The dismissal of claims against the third-party conspirators was affirmed in [an opinion](#) published yesterday.

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During [oral arguments](#) before the Delaware Supreme Court on December 15, Mr. Grant tried to correct the tactical error regarding imputation and Delaware vs. New York Law noted in the opinion with this excuse:

“Just because wisdom comes late it should not be ignored.”

That plea, obviously, cut no mustard with the justices.

[You Are There: A Review of “All The Devils Are Here”](#)

Jan. 21 2011

“I wasn’t there.”

That’s what Eliot Spitzer told me when asked about the resignation of Maurice “Hank” Greenberg from AIG in March of 2005. That story is one of many retold in Bethany McLean and Joe Nocera’s new book, [“All The Devils Are Here: The Hidden History of The Financial Crisis”](#).

Spitzer says:

“It was the AIG Board’s decision.”

There are [other versions](#) of that episode in print, [not all the same](#).

In their book, McLean and Nocera repeat the claim that Greenberg resigned because PricewaterhouseCoopers, AIG’s auditor, “would no longer vouch for the firm’s books if Greenberg stayed on as CEO.” It’s the same version of Greenberg’s resignation that Alex Gibney included in the documentary [Client 9: The Rise and Fall of Eliot Spitzer](#). And it’s the same set of details cited repeatedly by Peter Elkind in accounts at Fortune magazine and in his book, [“Rough Justice: The Rise and Fall of Eliot Spitzer”](#).

[Dick Beattie](#), the Simpson Thacher attorney hired by the AIG board, published his version in May 2008 in response to a Wall Street Journal editorial:

Mr. Greenberg was asked to step down for two principal reasons. First, in light of the information uncovered in AIG's internal financial review, AIG's auditors had determined that they could no longer rely on Mr. Greenberg's certification of the company's financial statements. This would have made it impossible for AIG to meet its filing requirements as a public company, the consequences of which would have been disastrous.

Second, Mr. Greenberg refused to comply with AIG's company policy — a policy he had approved as chairman and CEO — that AIG and its employees cooperate fully with any government investigation into AIG and its business.

This week Mr. Greenberg gave me his recollection:

“There was a special meeting of the Board over the weekend. I was not at that meeting. As I was returning to New York, I had been asked by Zarb to call in from time to time so that I could be told what, if any, conclusions were made by the Board. I did so, but it wasn't until Sunday, late afternoon, that both Zarb and Beattie got on the phone and stated that Spitzer had demanded my resignation or he would indict the company.”

The 364 pages of “All The Devils Are Here” are full of narratives like the one about Mr. Greenberg and AIG. They're tales I'd read before, in one version or another, with greater or less emphasis on certain details and, perhaps, subtle changes that can change the meaning for the close reader. In this case, it's a

tale that Greenberg and Spitzer might dispute but that, nonetheless, has become conventional wisdom.

McLean and Nocera go back to the beginning to describe what they say is a “hidden history of the financial crisis.” They start with the early 1970’s and the story of Larry Fink, [Lew Ranieri](#), and David Maxwell. These three are credited as the fathers of the mortgage-backed security and the process of securitization.

I’m guilty of reading almost every book about the financial crisis. I don’t read them all because, to be honest, it’s getting tedious. Many have a sing-song, made-for-TV-movie, storytelling style and the constant repetition of so many stories I’ve already heard is beginning to numb my sense of outrage.

What I do read I read with an eye towards their treatment of the auditors’ role in the failures and executive foibles. I’ve also selected, at this point, the stories I would tell if I were to explain what went wrong. I’m relieved to say no one has yet opined on the auditors’ role in any great detail or in any way close to how I would.

Some books came out too early in the timeline.

Larry McDonald’s version of the Lehman failure, [“A Colossal Failure of Common Sense”](#), is an insider’s and a trader’s perspective. It was published in July of 2009, before the [Lehman Bankruptcy Examiner’s Report](#) shed so much light on Repo 105 and the rest of the sins of Fuld and Co. In particular,

[Anton Valukas'](#) Bankruptcy Examiner's Report was the first time the word "fraud" was openly mentioned as a possible cause of a crisis-era failure and the first time anyone had publicly questioned an auditor, in this case Ernst & Young.

Andrew Ross Sorkin's "[Too Big To Fail](#)" is an exhausting encyclopedia of conversations, names, places, neckties and meals. Published in October of 2009, it also ends too soon with a meeting on October 13, 2008 between Bernanke, Geithner, Bair and nine Wall Street CEOs to distribute the TARP money. Sorkin characterizes it as the day we "effectively nationalized the nation's financial system" but, as debates over executive compensation and bonuses would prove, that wasn't quite what happened.

McLean and Nocera's book has some great back stories on the early days of colorful characters like Roland Arnall of Ameriquest. The extensive coverage of Angelo Mozilo and Countrywide is especially poignant since his future still hung in the balance at the time the book went to press. I'm happy they picked Countrywide as the demon mortgage originator instead of New Century, since I like the idea that [KPMG's sins were publicized in the New Century bankruptcy examiner's report](#). I'll use New Century.

All in all, the book tied a ton of names together with their incidents and connected a lot of dots, in particular with regard to [Fannie Mae and Freddie Mac](#). Not only have Fannie and

Freddie escaped serious reformation via the Dodd-Frank regulation but they'd escaped serious coverage in a book until now. The story of Deval Patrick's relationship with Long Beach Mortgage and the Ameriquest parent company board was also news to me.

"All The Devils Are Here" is not so much the "hidden history" of the financial crisis, in my opinion, as it is the backroom, Washington D.C., double dealing history of the financial services industry. The amount of soap opera goings on is embarrassing when you realize that billions of dollars and millions of people's homes were at stake. The greed and hubris displayed on these pages had a profound impact on our economic history. We should be hugely grateful to McLean and Nocera for documenting it as a reminder of what, and whom, to guard against in the future.