

TECHNICAL EXCELLENCE

AUDIT AND MANAGEMENT CULTURE

News reports as early as 2008 alluded to the possible improper manipulation of quoted LIBOR rates, and this burst into public consciousness in a big way from mid-2012. The basic allegation concerns the self-reporting of borrowing costs by major money centre banks, the compendium of which is then used to construct the index known as LIBOR (London Inter-Bank Offered Rate), which serves as the benchmark rate for huge amounts of debt throughout the world (for example, when loans are priced at “LIBOR + 1.5%”). The central allegation was that by under-reporting experienced borrowing costs, the LIBOR index could be gamed, thus tilting the playing field in favour of existing and many potential borrowers throughout the world financial system.

As often happens, particularly in litigious countries such as the US, the mere suggestion of a rate-rigging conspiracy led to a veritable paroxysm of political posturing, followed in short order by threatened or actual criminal and civil litigation. To date, this has resulted in the obtaining of large monetary settlements from many of the world’s largest banks, whose borrowing cost quotations presumably had been less than honest. The first



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THE LIBOR SCANDAL

Lessons for Auditors



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acknowledged malefactor, Barclays Bank, agreed to a US\$450-million fine levied by the US and UK authorities, and this settlement was followed by other settlements by governmental authorities with banks such as

JP Morgan, Rabobank, DeutscheBank, Société Générale, RBS, UBS and others; private lawsuits are continuing as well.

The true nature and severity of these breaches will eventually become known, and won't be given speculative attention here.

Instead, our concern is with whether independent auditors can be said to have failed to appreciate this

risk, and whether there are lessons to be learned that will possibly improve the practice of auditing in future. With the ever-present likelihood of auditor liability litigation, this question is worth asking.

HISTORY OF LIBOR

The development and eventual prominence of LIBOR as a reference borrowing rate closely tracked the explosive growth in the use of financial derivatives, beginning around the mid-1980s. The expanding need or desire to know what costs would attach to borrowings – defined in terms of maturity and currency – led to the surveying mechanism that produces a set of consensus estimates of hypothetical borrowing costs. Today, these estimates are provided by a panel of 18 banks, quoting presumptive costs associated with various supposed loan terms.

These putatively honest, independent estimates are essentially averaged to compute the LIBOR rates *du jour* (along with their close relatives, such as EURIBOR).

The panel member banks are quizzed about the rate they would expect to be charged to borrow funds, were they to do so by asking for and then accepting inter-bank offers in a reasonable market size just prior to 11 am each day. Currently, LIBOR rates are provided for 10 currencies, in 15 maturities ranging from overnight to 12 months. The important point – and, it should be noted, one not hidden from users of this information – is that these are subjectively assessed rates on imaginary loans, not based on actual, consummated lending transactions.

AUDITORS' RESPONSIBILITIES FOR ASSESSING FINANCIAL REPORTING RISK

Independent accountants conduct examinations of reporting entities' financial statements, and render opinions regarding material compliance with standards such as the US generally-accepted accounting principles (GAAP). In planning and performing these audits, the accountants are required to assess a range of risks, and adjust the nature and scope of their procedures accordingly. Auditors are required to at least understand the reporting entities' controls over their financial reporting processes, and if reliance thereon is desired – to reduce audit effort and cost – the effectiveness of those controls must be tested and found acceptable.

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not stealing from it. In effect, this would have been akin to a company overcharging its retail customers: as long as its revenues and/or costs are properly recorded and classified, no financial reporting irregularities can be said to have occurred. The auditors' "clean opinion" might not be unwarranted, even if such behaviours are seen as distasteful.

What then should be the auditors' concern about these alleged instances of LIBOR-quoting chicanery?

MANAGEMENT INTEGRITY, TONE AT THE TOP, AND THE ABILITY TO CONDUCT AN AUDIT

In assessing their ability to rely, to the limited extent permitted by auditing standards, on managements' representations, the auditors consider a range of controls-related matters, one of the most important being the so-called "tone at the top". It has been well established that a culture of corruption at the upper echelons of management – or even a

permissive attitude that allows even minor infractions, such as expense account padding, to exist – will be observed and mimicked by those in the lower ranks, creating opportunities for asset thefts and reporting frauds of all types.

For this reason, a tolerance for, or active encouragement of, even those violations having no material effects on the entities' financial statements, should be of acute interest to auditors



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Simply put, lenience regarding these seemingly victimless infractions must be seen as requiring consideration in the assessment of internal control risk. At the extreme, if top management has abetted a climate that permits or encourages inappropriate behaviour, the auditors' ability to have faith in management's integrity will be threatened, perhaps to the point that the very conduct of the audit is rendered impossible.

as indicia of a "tone at the top" that might signal the presence of more significant risks to the integrity of the financial reporting process.

Not being sensitive to this opens the door to allegations of accountants' malpractice.

It has yet to be demonstrated that the shading of LIBOR rates had a material impact on any entity's borrowing costs or investment returns. Neither can it yet be confidently asserted that the banks' auditors failed in conducting their audits even if these practices did serve to cause some economic harm to their counter-parties or third parties relying on LIBOR to price various assets. However, it is clear that auditors should see this episode as yet another teachable moment. Tone at the top is more than just a vague notion; it is central to risk assessment. ISCA

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