The LIBOR Scandal: Are There Lessons for Auditors?

By

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Recent news about the apparently improper manipulation of quoted LIBOR rates has already precipitated a veritable paroxysm of political posturing, and has snared its first acknowledged malefactor, Barclays Bank, which has agreed to a $450 million fine levied by U.S. and U.K. authorities. Further regulatory challenges, quite possibly expanding to other LIBOR rate-declaring banks, and a spate of private lawsuits by assorted borrowers claiming to have been over-charged or otherwise abused by this perverted system, will certainly be forthcoming. This in fact shows signs of being able to produce a litigation feeding frenzy perhaps unequaled since the stock option backdating scandals of the mid-2000s.

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 the future. With the ever-present likelihood of auditor liability litigation, this question is worth the 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 it would expect to be charged to borrow funds, were it to do so by asking for and then accepting inter-bank offers in a reasonable market size just prior to 11 a.m. each day. Currently, LIBOR rates are provided for ten currencies, in fifteen 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 U.S. generally accepted accounting principles. 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.

Auditors also must assess various other risks, including the risk of financial reporting fraud. Regarding the matter of manipulated LIBOR rates, if a fraud occurred, it was perpetrated by the reporting entity on some of its actual customers or counter-parties, for the purpose of enriching the reporting entity, 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 behaviors 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, 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. 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 behavior, 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. 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.

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