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Corporate Collapse and the Role of Audit Committees: A Case Study of Lehman Brothers

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This paper examined the roles and effectiveness of Audit Committees (herein ACs) as provided by corporate governance codes, in relation to corporate failures, whether the failure is as a result of the ineffectiveness of the ACs. Given that the AC is perceived to be a means of strengthening the external financial reporting process and facilitating the detection and prevention of corporate misconducts and scandals. It is believed that many financial and governance failures experienced in the recent past could be detected much earlier, had ACs been discharging their duties effectively. Secondary sourced data were used to investigate the roles of AC in the case of Lehman Brother's corporate failure. A qualitative case study method was employed to carry out the study, by identifying and evaluating specific areas of interaction between ACs and other parties which affect audit process. The finding shows that many corporate failures are associated with the ineffectiveness of ACs, and that ACs could have prevented the occurrence of several corporate failures if they were efficient. However, the ACs cannot be 100% blamed for the failures, this is because their effectiveness is subjected to so many factors, and lack of any one factor always renders the AC ineffective. Some of the findings are consistent, while others are contrary to previous empirical studies on effectiveness of ACs. The study exposed specifically the process involved in the conduct of ACs in an organization and this add to the current debate on the need for improvement in the roles played by the AC as public gatekeepers.

Keywords: Corporate Governance and Audit Committee

1. Introduction

The contemporary Audit Committees (herein AC) concept began in the late 1930's when the US Security and Exchange Commission (SEC) recommended that publicly held companies form a Committee of non-officer board members that would assure the independence, Nomination and arrangement of engagement process of external auditor (Fichtner, 2009). Afterward, the ACs played a vital role in the governing Structure of public companies (Oshima, 2005). In the last two decades ACs become a commonly used mechanism for good corporate governance practice globally (Turley and Zaman, 2004).

Many legislations and corporate governance reforms have increased the responsibilities, tasks and expectations from the ACs (Bruynseels and Cardinaels, 2013). Thus, their effectiveness becomes an issue of concern to both researchers and regulators, the growing public pressure has placed a greater deal for emphasis on ACs role in pursuit of

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effective corporate governance, the result from the investigation of collapsed companies indicated with clarity that almost every financial and governance failure, the world has experienced in the recent past could have been detected much earlier (Harrast, 2007).

Hence, this study figure out the actual role and responsibilities of ACs to understand the major determinants of effective discharge of ACs duties and to know whether the effectiveness of ACs will reduce the rate of corporate collapse and enhance the effectiveness of corporate governance. This study explore the unexplored research area in ACs studies, to contribute to the case study research approach by illustrating the in-depth that can be derived from a case study approach, investigates the ACs process from within the organization and to see how organizational context affect the operational process of the ACs. The research specifically addresses some of the unanswered questions ACs research, therefore in view of the changing role/ responsibilities of the ACs the research focus on the following:

a. *Are Audit committees to blame for audit/corporate scandals?*
b. *Will Audit Committees prevent future audit/corporate scandals?*
c. *Are the corporate scandals a reflection of ineffectiveness of Audit committees?*

The paper is structured as follows:

The paper begins with 1. Introduction to the research topic, followed by 2. Review of existing literature related to ACs, looking at the 2.1 roles of ACs, 2.2 effectiveness of ACs, 2.3 the need for ACs. Then 3. Methodologies employed in the research with reference to quantitative and qualitative and the justification for choosing a particular method. Afterward, 4. Research findings, 4.1 background of Lehman Brothers, 4.2 the ACs of Lehman, results and evaluation of Lehman Brothers and answers to research questions 4.2.1 review of financial reporting process, internal control and disclosure requirement, 4.2.2 the use of Repo 105, 4.2.3 responsibility for prediction and prevention of fraudulent act, 4.2.4 availability of information and ACs roles, and finally 5. the conclusion and summary of findings.

2. Literature on Audit Committees

2.1 Roles of Audit Committees

The need for ACs came amidst of unexpected corporate failures that stem from corporate misconduct (Mohammed et al, 2005). ACs was non-mandatory structure used by few corporations on recommendations by court as means of settling allegations of corporate misconduct. In recent years, a number of professional and regulatory commissions in the US, UK and many other countries have recommended the adoption of the concept and increased their advocacy on the expanded roles of the ACs. Notably are the Sarbanes-Oxley Act of 2002 in the US, the report of Australian treasury (2002), the recommendation of Smith Committee (2003) and the Higgs review (2003) in the UK (Turley et al, 2003). In 2008, a guide was issued in the UK on ACs elaborating the roles of ACs: monitoring and reviewing the integrity of financial statements and reporting judgements, review of internal controls where necessary and monitoring of effectiveness of internal audit, recommendation of appointment of external auditors (EA) and associated cost, review of EA's independence and effectiveness and the development and implementation of policy.

Noteworthy, the roles of ACs are based on different legislative traditions in different countries. For example, the roles of ACs have been undertaken by other bodies such as supervisory boards or the board of directors in some countries.

2.2 Effectiveness of Audit Committees

Significant number researches established that the mere formation of AC in organization result in substantial benefits. For example Beattie et al (1999) found that the presence of AC is significant factor in enhancing third party perception of auditor independence. McMullen's (1996) further supports the above assertions. Goodwin-Stewart and Kent (2006) argued that ACs are associated with higher quality audit. However, these findings are in conflict with the result of Beasley (1996) which concluded that the presence of AC has no significant effect on the likelihood of financial statement fraud and that interaction of the AC with board does not impact on the likelihood of financial statement fraud. It was further suggest that the board composition is more likely to constrain fraud in an organization than AC. Peasnell eta al (2005) and Pucheta-Martinezand de Fuentes (2007) confirmed this argument. Da Silveira (2013) suggested that a new behavioural approach to corporate governance focusing on the psychological aspects of human being inside organization need to be evolved. This suggestion came after a careful examination of eight cases of corporate scandals by Hamilton et al, (2006).

2.3 The Need for Audit Committee

The continued changes in business environment, and increase in complexities of modern day corporations necessitate the need for the establishment of ACs to enhance the governance process of those corporations. Similarly, the growth and increase in corporate activities result in increased risk and responsibilities of corporate directors, the need to reduce the risk further increase the need for an AC as the means of reducing such risk. Consequently, AC became an addition to the corporate practice (Mautz et al, 1977 in Brenda, 1986). As more interest group evolve with keen interest on the activities of corporations, the AC is viewed as watchdog for the distance interest group who has no direct access to what is happening in those corporations. Those who argue on the need for ACs emphasized that AC ensures good relationships between directors, investors and auditors. AC also helps in the discharge of accountability and directors execution of their responsibilities. ACs influences power relations between accountability and auditing (Turley and Zaman, 2004).

ACs are often perceived as an effective mechanism reducing agency cost and are expected to monitor the reliability of the company's accounting processes and compliance with relevant corporate legal and ethical standards which includes maintenance and prevention of fraud controls (Hemraj, 2004 and Turley and Zaman, 2004). However, many research on the ACs effect on corporate governance revealed that it is not all of these perceived potentials were achieved by adoption of AC concept, rather in some cases the ACs aides the perpetration of most of the corporate scandal the world witness either deliberately or out of non-commitment to their duties as prescribed in the governance Codes, like the cases of Enron in 2001 and number of scandals involving large US companies such as world.com and global crossing (Sharma, 2009).

3. Methods

The study is design to recognise the dynamic operation of ACs in an organizational context, which provides clear evidence on what is actually happening to ACs members in the process of discharging their duties. The study reviewed Secondary data from data banks, and analysed the details as they relates to the roles of AC's in the failure of Lehman. A case study allows for deep understanding of a situation (Creswell, 2007). The researcher employed a qualitative case study method to investigate the roles and effectiveness of ACs in the failed companies, using several data sources, including available public information, academic journals, public legal findings and reports of investigation committees. After series of investigations in the failure of Lehman Brothers, many documents became available publicly which provided rich real-time pictures of what happened in the companies. Some reputable press articles and publications (financial times, wall street journal, CNN-IBN, business outlook) were used to examine the corporate scandals.

The case study looks at one of the largest fraud Case of Lehman Brother plc (termed as the largest corporate scandal in the history of USA). The case involved fraud and manipulation of financial statements which was perpetrated by the top management for a long period without being spotted by the established monitoring mechanism. Different research method has been employed in the study of ACs; this study Case study appears to be appropriate to study how ACs operates in their social, political and economic context. Turley and Zaman (2004) states that qualitative research method using case studies provide significant potential for researching ACs activities in the organizational and institutional context in which they operate, adding that cases may allow identification of specific areas of interaction between ACs and other parties like executive management and auditor which affect audit process.

4. Research Findings

4.1 Lehman Brothers

Lehman Brothers started as a small general store at Montgomery, Alabama in 1844. Henry Lehman, an immigrant from Rimpar, Germany, founded it. Established as a small shop selling groceries, dry goods and utensils to the local cotton farmers. In the year 1850, his two brothers joined him in the business and jointly named the business LEHMAN BROTHERS. In 1858, they opened a New York office, and that gave them the chance to spearhead the formation of the New York cotton exchange in 1870. During depression in 1930's, Lehman was the first firm to come up with a new method of financing known as the private placement when companies were unable to raise capital. The economic expansion of 1950's which was driven by electronic and computer technology, Lehman Brothers was deeply involved in the investment opportunities in the sector, and engaged in underwriting digital equipment corporation's first public offering. In the 1960's and 1970's the firm expanded its tentacles, and. In 1980's Lehman Brothers acted as advisor on several large U.S and cross -border transactions taking part in the new market as a result of computer boom by backing companies like Intel.

American Express in 1984 acquired Lehman Brothers and merged with retail brokerage Shearson to form Shearson Lehman Brothers but later pulled out and once again became Lehman Brothers. In 2000, Lehman celebrated its 150th anniversary. Lehman was the fourth largest US investment bank at the time of its collapse, with 25,000 employees worldwide. It was the largest victim of the US subprime financial crisis that collapsed the global financial markets in 2008. On 15 September 2008, Lehman filed for Chapter 11 bankruptcy, with $639 billion in assets and $619 billion in debt, making it the biggest in history (HBS, 2014)

4.2 The Audit Committee

The AC of Lehman Brothers existed for some time, due to the long-standing institutional practice in the company, Consistent with the Sarbanes Oxley provision, the AC reports on their roles in the annual account of Lehman Brothers.

4.2.1 Review of Financial Reporting Process, Internal Control and Disclosure Requirement

"We continue to be committed to industry best practices with respect to corporate governance. Our Board of Directors consists of ten members. With the exception of our CEO, all of our directors are independent. The audit, nominating, and corporate governance, finance and risk, and compensation and benefit committee are exclusively composed of independent directors. The AC includes a financial expert as defined in the SEC's rules. The board holds regularly scheduled executive session in which non-management directors meet independently of management. The board and all its committees each conduct a self-evaluation at annually. Last year, overall director attendance at board and committee meetings was 96%. We have an orientation program for new directors. Our corporate governance guidelines also contemplate continuing director education arranged by the company. Our Code of ethics is published in our website. We have designed our internal control environment to put appropriate risk mitigants in place. We have a global head of risk management and a global risk management division, which is independent. The company's management assessed the effectiveness of our internal controls. Based on our assessment, we believe that the company's internal controls are effective over financial reporting. Independent auditors have also considered these controls effective. We also sponsor several share-based employees' incentives." (Lehman Brothers Annual Report 2007 in Da Silveira 2013).

Above is an excerpt from the Annual Report of Lehman Brothers a few months before it collapse, which portrays how robust the company is in adherence to Sarbanes Oxley provisions and good corporate governance practice. But sufficient evidence contradicts the assertion of the company's management for being adherence to best governance practice as observed by Bris (2010), that Lehman was bankrupt right before September 2008. This make legal expert to believe that Lehman executives deliberately manipulated information in the statements, and the auditors and AC purposely closed their eyes to these balance sheet manipulations as early as 2000's (Morin and Maux, 2011). Especially in the use of Repo, significantly Lehman used Repo 105, and failed to disclose it to the government, rating agencies, investors, and the board of directors. It is believed that the auditor and the AC were aware of the situation, and sufficient evidence from the bank examiner's report findings indicates a breach of fiduciary duties. However, the report states clearly that the board of directors was unaware of Lehman's Repo 105 program and transactions (page 945).

Lack of industry knowledge is a factor as found by Cohen et al (2008) that AC members with industry expertise are likely to have superior ability for understanding, interpreting and assessing the quality of financial reports than members with no industry expertise. However, when the top management takes control of the board agenda, the AC might not be able to get right information to discharge it oversight duties (Beasley et al, 2009).

4.2.2 The Use of Repo 105

Repo is a financial instrument used by financial institutions routinely to transfer securities under short-term arrangement to finance immediate liquidity needs. On who to control the transfer asset FAS 140 provided that it should be treated as a financing arrangement or sale (Jeffers, 2011 and Azadinamin, 2013). Although, Repo 105 was in line with American accounting standards, it purpose in Lehman was to deceive and they used techniques to reduced it reported leverage substantially (Morin and Maux, 2011). And it is observed that financial statement fraud techniques vary by industry. In technology companies, the identified techniques are in revenue recognition, while financial services sector's fraud techniques relate to misappropriation of asset (Beasley, 2000). This is again confirmed by Cohen et al (2010a) that AC members with strong industry expertise would have sufficient knowledge to assess the business activities and risk to be able to evaluate the appropriateness of the use of accounting methods and whether estimate are realistic, leading to higher quality financial reporting.

Lehman reported having over twenty operating committees to review risk decisions as they claim "*Risk management is one of the core competencies of the firm*" (Valukas, 2010). Ultimately, the risk management structure appeared to be ineffective and dysfunctional as they were disregarded in most cases of risk assessment (McDonald and Robinson, 2009, Dziedzic, 2010, and Winford, 2013). From all account, it appeared that *"the top management wilfully certified the accuracy of financial statement knowing they were inappropriate, and an accounting scandal was in making and the Sarbanes Oxley Act was violated"*. This is because of the ineffectiveness of the instituted watchdog due to power relation existing between the AC and the management as observed by Turnbull (2004), that AC have not been working and cannot be relied upon to protect investors unless they become a separate board elected by investors on democratic rather than a plutocratic basis. AC is increasingly failing to deliver on their responsibilities due to lack of risk awareness system in most of the organizations (Robin, 2013).

4.2.3 Responsibility for Prediction and Prevention of Fraudulent Act

The discharge of these duties is lacking as claimed by Morin and Maux (2011) that warning signs were apparently visible to detect the possibility of the bankruptcy, arguing that auditors and AC ignored the statement of cash flows in their analysis as examination of the statement revealed that "*Although Lehman Brothers had $7.286 billion in cash and cash equivalents on November 30, 2007, an analysis of its cash flows signal a major dysfunctions in working capital management. Specifically, this is shocking for financial instruments: over a three year period, they generated net negative cash flows of $161.657 billion.*" The inability to predict the catastrophe through analysis clearly indicates that the AC either did not understand the statement or were blind folded by superficial performance, which did not allowed them to be inquisitive on a matter of concerns for more details (Vera-Munoz, 2005).

Although, it is not the primary roles of the AC to detect a fraud, but it is expected the auditors and AC working together should discover frauds or errors, which are material to the financial statement (Hemraj 2004). The AC's first priority should be to make sure financial projections are sound (Sherman et al, 2009). But that appeared to be lacking in the case of Lehman brothers. Conclusively, Azadinamin (2013) stated that the net negative cash flows signal a deficiency which could have been prevented. Nevertheless, the AC and the auditors failed to recognize the lack of correlation between the statement of cash flows with balance sheet and income statements. More so, the 2005-2007 statement of cash flows of Lehman gave clear prediction of the coming bankruptcy. Morin and Maux (2011) enumerated the signs for the distress in the cash flows statement to include:

i. *"Chronic inability to generate cash from operating activities*
ii. *Massive and systematic investment in working capital items and even more intensive investment in financial tools and instrument.*
iii. *Systematic use of external financing to offset operating deficit, in which mainly included long-term debt.*
iv. *Steady deterioration of cash flows over three years leading to crisis.*

These were enough warnings for disaster appearing in the near future; the top management were aware as members of Lehman tax department, maintain that they were also aware of the trouble ahead (Snowdon, 2009). The system of bonuses in the investment-banking sector has been identified as contributing factor toward substantial risk taking, and some firms had limited understanding and control over their potential balance sheet and liquidity needs that most of the allege fraud activities were undertaken by top management members who want to look like an exceptional traders and achieve a higher bonuses. The AC needs to better understand the behaviour and risks that a company's incentive plans encourage and whether such risks are appropriate (Kirkpatrick, 2009). In this regard, Caplan et al (2010) mention that in 2006, Lehman made a deliberate decision in pursuing a higher-growth business strategy, by switching from a low-risk brokerage model to capital-intensive banking model, where they buy and stored asset, which primarily should have been moved to the third party.

4.2.4 Availability of Information and Audit Committee Roles

According to Lipman (2013), the effectiveness of AC can only be guaranteed when there is an effective and independent source of information, the ability of the AC to obtain information independent of the CEO and the CFO is crucial for effective oversight. The AC of Lehman Brothers were not well informed on what was going on with Lehman, as the Examiner's report found that "*sufficient evidence show that Mr. Matthew Lee forwarded a whistle-blower letter to the independent auditors apposite to Lehman Repo 105 activities and reporting on $50 billion in the second quarter 2008, but the auditors failed to informed the AC of Lee's allegations, while they were aware that the financial information may be materially misleading because of the failure to disclose the effect of the Lehman Repo 105"* (Examiners report volume 3 p.1033). Although, the AC make an effort during a meeting with the internal and external auditors by requesting the external auditor to assist with the investigation into the allegations made by Lee, the external auditor refused to informed the AC about the Repo 105 claims by Lee, even though the AC asked to be told about each allegations (Azadinamin, 2013).

The Actions of the external auditors and lawyers are clear negligence of duties, as both are in the best position to assist in the evasion of 'good faith' obligations of an investment bank and has a burden of protecting the public from 'shams transactions (Hansen, 2010). Evidence also showed that "*In the first quarter of 2008, while other investment bank were* *reporting massive losses from written-downs heavy commercial and residential real estate holdings, Lehman reported a profit by manipulating it equally troubled real estate portfolios comprised of $25 billion in prime."* (Winford, 2013). According to Jeffers (2011) Lehman engaged in creative and deceitful accounting practice, which temporarily removed securities and troubled liabilities from Lehman balance sheet, recording the transactions as sales while reporting quarterly financial result to public. The AC was unable to questions that due to cover up by the management of the company and they lack information from other sources. In most cases, as identified by Beasley et al (2009) that the management may take over the agenda setting process like the case of (Enron, WorldCom and Hollinger) where the senior management took control of the agenda and were able to control the flow of information to the board and the AC. Beasley concluded that "*information timeliness can be an important issue and may reduce the ceremonial role played by AC*." This confirm the explanation of Robert et al (2005), who said that information asymmetry always exist in the board and the independent directors are always on the unprivileged side of this asymmetry.

5. Conclusion and Summary

This paper examined the roles and effectiveness of AC in the face of incessant corporate failures, Over the past 7 decades, the AC concept is receiving a considerable attention and growing from a committee saddled with the responsibility of Nominating and arranging the engagement process of independent auditors to a Committee now responsible for overseeing the integrity of the financial statements of company, the review of the company's internal financial control and monitoring and reviewing the effectiveness of the company's internal audit function. The result of this research would be of enormous importance to researchers and regulatory agencies while formulating policies on good corporate governance. As it conforms to agency theory and some findings of previous studies, however some of the findings are new.

In this case, the perpetrated fraud could have been prevented if the ACs were proactive in the discharge of their duties, because the signals existed long before the occurrence of the failures. However, lack of information, which should have been supplied by the auditors and whittles blower prevented the AC from predicting the looming failures facing the companies. It is also found that the readily available information at the disposal of the AC is the one provided by the management whom the AC is to monitor, however, it was suggested by Lipman (2013) that the effectiveness of AC can only be guaranteed when there exist and effective and independent source of information.

The study also found that effectiveness of AC is not determined by either mandatory or voluntary AC, as in the case AC establishment is a mandatory requirement. All that is needed is the understanding of the sector specifics risks associated with the company. Lack of harsh punishment on the negligence of AC members also contributes to the laxness of the AC in the discharge of their duties. The concept of AC entirely failed to recognized behavioural aspect of human being in the formation of AC, while certain personality trait could not be ignored. The result would have been more interesting if primary data from questionnaire and observation were used, however the result have added to the continued debate on the role of AC.

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