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(Photo: Bloomberg News)

MF's missing $$$ makes you wonder about Goldman, JP Morgan: Weil

Accounting firm that signed off on bankrupt B-D's books also auditor for Wall Street titans

By Jonathan Weil
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Six months ago the accounting firm PricewaterhouseCoopers LLP said MF Global Holdings Ltd. and its units “maintained, in all material respects, effective internal control over financial reporting as of March 31, 2011.” A lot of people who relied on that opinion lost a ton of money.

MF Global filed for bankruptcy on Oct. 31. This week the trustee for the liquidation of its U.S. brokerage unit said as much as $1.2 billion of customer money is missing, maybe more. Those deposits should have been kept segregated from the company's funds. By all indications, they weren't.

What's the point of having auditors do reports like this? And are they worth the cost? It's getting harder to answer those questions in a way the accounting profession would favor.

When an auditor certifies that a client's internal controls are effective, that's supposed to mean the company can do basic functions like maintain accurate financial records, detect unauthorized transactions and keep track of its receipts and expenditures. We know MF couldn't do these things during the final days before its bankruptcy filing, when former New Jersey Governor Jon Corzine was still its chief executive officer.

“Their books are a disaster,” Scott O'Malia, a commissioner at the Commodity Futures Trading Commission, told the Wall Street Journal in an interview two weeks ago. The newspaper also quoted Thomas Peterffy, CEO of Interactive Brokers Group Inc., saying: “I always knew the records were in shambles, but I didn't know to what extent.” Interactive Brokers backed out of a potential deal to buy MF last month after finding discrepancies in its financial reports.

Getting It Right

So, to believe Pricewaterhouse got it right when it blessed MF's controls in May, you would have to accept the notion that MF's controls were effective in March -- and didn't start going bad until sometime later.

Although we shouldn't rule out anything, this scenario seems implausible. One lesson from the 1980s savings-and-loan crisis is that whenever a financial institution fails, it's almost always true that its internal controls were poor -- and had been that way for a long time. Otherwise it wouldn't have failed.

There's more at stake here than the missing $1.2 billion. Besides MF, other companies that use Pricewaterhouse's New York office as their auditor include Goldman Sachs Group Inc. and JPMorgan Chase & Co. Both banks presumably are too big to fail, meaning taxpayers would be on the hook if they ever blew up. A Pricewaterhouse spokesman, Caroline Nolan, declined to comment on the firm's work for MF.

If Pricewaterhouse can't spot control weaknesses at a relatively small shop like MF, which had $41 billion of assets, it's a bit much to expect that the firm would catch anything materially amiss at Goldman, which has $949 billion (GS) of assets, or at a serial acquirer such as JPMorgan, with $2.3 trillion (JPM) of assets.

Fortunately for Pricewaterhouse, there's no better alternative. What's Goldman or JPMorgan going to do? Switch to KPMG LLP? Or Ernst & Young LLP? Or Deloitte & Touche LLP? Their track records are no better.

The reason MF had to get an outside audit report on its internal controls was that the Sarbanes-Oxley Act required it. That law was enacted in 2002 in response to a wave of audit failures at big companies such as WorldCom Inc. and Enron Corp.

Thanks in part to the new workload, audit fees at the Big Four accounting firms skyrocketed. So, too, did the number of financial restatements by public companies, which seemed to show the auditors were drilling down and catching lots of errors. For a while, it looked like the new rules were working.

Audit Backlash

Then a backlash hit. Corporate executives, lawmakers and even Securities and Exchange Commission officials complained that the auditors were being too strict. The number of restatements plunged. Audit fees stopped soaring and overall have been little changed since 2007, according to a report in July by Jack Ciesielski, editor of the Analyst's Accounting Observer newsletter.

Many companies' audit fees plunged, suggesting that the auditors there were doing less work. For fiscal 2007, MF Global paid Pricewaterhouse $17.1 million in audit fees. By fiscal 2011, that had fallen to $10.9 million, even as warning signs about MF's internal controls were surfacing publicly.

In 2007, MF and one of its executives paid a combined $77 million to settle CFTC allegations of mishandling hedge-fund clients' accounts, as well as supervisory and record-keeping violations. In 2009, the commission fined MF $10 million for four instances of risk-supervision failures, including one that resulted in $141 million of trading losses on wheat futures. Suffice it to say, Pricewaterhouse should have been on high alert.

On top of that, Pricewaterhouse's main regulator, the Public Company Accounting Oversight Board, released a nasty report this week on the firm's audit performance. The agency cited deficiencies in 28 audits, out of 75 that it inspected last year. The tally included 13 clients where the board said the firm had botched its internal-control audits. The report didn't name the companies. One of them could have been MF, for all we know.

In a response letter to the board, Pricewaterhouse's U.S. chairman, Bob Moritz, and the head of its U.S. audit practice, Tim Ryan, said the firm is taking steps to improve its audit quality. We've heard this kind of talk before, though.

The point of having a report by an independent auditor is to assure the public that what a company says is true. Yet if the reports aren't reliable, they're worse than worthless, because they sucker the public with false promises. Maybe, just maybe, we should stop requiring them altogether.

(Jonathan Weil is a Bloomberg View columnist. The opinions expressed are his own.)

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