ARE AUDITORS AT FAULT FOR THE COLLAPSE OF FINANCIAL INSTITUTIONS IN LITHUANIA?

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ABSTRACT
The experience of the global financial crisis revealed that while many financial institutions were allowed to take excessive risks, the auditors failed in their duties to reasonably evaluate those risks as well as to inform the investing public about them. The issues of statutory auditors' liability and their public role are particularly relevant in Lithuania, considering the fact that over just the past few years the third and the fourth largest banks in Lithuania turned out to be insolvent. Analysis of legal actions against auditors of these banks highlighted certain shortcomings in the audit market and auditors'
liability regulation, related to the quality and transparency of audit reports, auditors’ accountability and independence requirements, and insurance of auditors’ liability.

In the first part of the paper the case analysis of Ernst & Young Baltic’s responsibility for Snoras bankruptcy as well as Deloitte’s responsibility for Ūkio bankas’ insolvency, and discussion of the cases, are presented. The second part of the paper deals with the changes in regulation of the audit market in Lithuania and Europe, and issues left outside the reform.

KEYWORDS
Bankruptcy of banks, liability of auditors, regulation of audit market, insurance of auditors.
INTRODUCTION

In recent years, the experience from the Global Financial Crisis of 2008, when many financial institutions all over the world were nationalized, taken over, or declared insolvent and liquidated, while disturbing entire economies, showed that the role of auditors as gatekeepers in the financial services sector is as important as ever. The experience from the Global Financial crisis of 2008 also revealed that while many financial institutions were allowed to take excessive risks, the auditors failed in their duties to reasonably evaluate those risks as well as to inform the investing public about them. Many financial institutions were given unqualified auditors’ opinions, despite substantial losses incurred in 2007 and later. In the Response to Consultation on EC GREEN PAPER: “Audit Policy: Lessons from the Crisis” by Maastricht Accounting, Auditing & Information Management Research Center (MARC) of Maastricht University the authors affirm that “it is clear that the market was not well informed as to the nature of the risk exposures developing in many sizable financial institutions. ... At a minimum, the public needs assurance that the auditors themselves understand the complexity of these activities and risk exposures”¹. European Commission (EC) also states that “doubts have emerged amongst investors on the credibility and reliability of the audited financial statements of banks, other financial institutions and listed companies.”² Also, “inspection reports from the Member States revealed instances of a lack of professional skepticism by statutory auditors, misstatements, and a lack of fresh thinking in the statutory audits of major companies.”³

The banking sector is considered one of the most sensitive sectors of the economy. Maintaining public confidence in the banking system is one of the essential elements of the banking sector. As Christine Lagarde, director International Monetary Fund noted:

One of the main casualties [of the Great Recession] has been trust—in leaders, in institutions, in the free-market system itself. ... In this age of diminished trust, it is the financial sector that takes last place in opinion surveys. This might not be surprising in light of some of the behavior that triggered the global financial

crisis. But it is nevertheless disturbing. As many have pointed out, the very word
credit derives from the Latin word for trust.\(^4\)

Once trust in the financial sector is lost, it can spread general panic. A banking crisis can result in other significant adverse consequences both for the society and individuals. Bankruptcies of financial institutions can be detrimental to any country’s financial system, but these situations are extremely threatening for the fragile system of emerging economies. It is clear that in these circumstances public trust in the financial sector is related not only to the competence of its actors but also to the ethical standards they follow. The public needs assurance that unethical and or even criminal behavior would not be tolerated or overlooked. The system has many safeguards, including audit committees, external auditors, credit rating agencies, lawyers, and supervising government institutions, whose objective is to oversee the activities of public interest entities. The external auditors’ purpose by definition is to assure that audited entity’s financial statements are fairly stated and inform the investing public about the accurate financial situation in such entities. Only those who both have the skills and precisely follow ethical standards can deliver the expected audit quality.

The issues of statutory auditors' liability and their public role are particularly relevant in Lithuania, considering the fact that in 2011 then the largest Lithuanian domestic bank, the third largest bank by deposits and the fifth by assets\(^5\) – Snoras – became insolvent due to alleged fraud and misappropriation of assets; and a few years later the fourth largest bank in Lithuania by deposits, Ūkio bankas, turned out to be insolvent mainly due to the irresponsible actions of its main shareholder, who used the bank’s assets to finance business projects related to him. Notably, both of the banks had unqualified auditor’s opinions issued by statutory auditors less than a year before the banks became de facto insolvent. The analysis of the legal actions against the auditors of Snoras and Ūkio bankas that is presented in this article highlights certain shortcomings in audit market and auditors' liability regulation related to the quality and transparency of audit reports, auditors’ accountability and independence requirements, and insurance of auditors’ liability. These problems are systematic not only in Lithuania but in all over Europe. Because legal regulation of the financial markets was unable to keep pace over the past fifteen years, the structure and the key features of the global financial system have changed dramatically.


This article is a complementary discussion to a discussion of the reasons for the crisis of financial institutions in 2011-2013, in Lithuania after the Global Financial Crisis. The article “The Bank and Credit Union Disasters in Lithuania: Where Were the Lawyers” (2015) analyzes why lawyers were not effective gatekeepers of risky behaviour of financial institutions. Accounting fraud is also one of the common features of collapses of not only banks in Lithuania, but also global corporations, like Enron, WorldCom, Tyco, the failure of Lehman Brothers and others. Thus, the purpose of this paper is to shed the light on the role of auditors as professionals, who shall also serve as gatekeepers in such situations, but, as it turned out in the aforementioned collapses, even well-known international audit companies can fail.

In the first part of the article the case analysis of Ernst & Young Baltic’s responsibility for Snoras bankruptcy as well as Deloitte’s responsibility for Ūkio bankas insolvency and discussion on the cases are presented. The second part of the article deals with the changes in regulation of audit market and issues, which were left outside the reform.

It is one of the first attempts in Lithuania to scientifically analyse the legal responsibility of auditors after bankruptcies of financial institutions. As a matter of fact, the consequences of bankruptcies of sizable financial institutions are long lasting and still very palpable today. It should also be noted that the conclusions of the article “The Bank and Credit Union Disasters in Lithuania: Where Were the Lawyers” (2015) are applicable for auditors’ liability, especially analysis of incentives of professionals misconduct in terms of psychological biases, the pressures of organizational culture, and so forth.

1. THE BANK AND CREDIT UNION DISASTERS IN LITHUANIA: THE ROLE OF AUDITORS

During the period of its independence Lithuania has seen sixteen banks go bankrupt—twelve of them in 1994-1995. However, in 2011-2013 two banks—the fifth and the sixth largest banks in the country—suffered bankruptcies and three credit unions collapsed. These debacles nearly brought the entire Lithuanian financial system to its knees, resulting in banking crisis. Moreover, the biggest credit union “Vilniaus taupomoji kasa” collapsed in 2014. Activity of another credit union “Amber” was restricted in the summer of 2016 and alarming news about shaky activity of some other credit unions was disseminated through the media.

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7 Ibid.
8 Lithuanian independence was restored in March of 1990, so just over twenty years ago.
For empirical analysis of auditors’ role and liability in insolvencies of financial institutions we selected the cases of Snoras and Ūkio bankas bankruptcies in Lithuania. It should also be noted that bankruptcies of Snoras and Ūkio Bankas, which are analysed in this paper, can barely be associated to the recent financial crisis, which peaked in 2008-2009, but rather with the systematic issues of corporate misconduct. It should also be noted that until the noisy collapse of Snoras bank, no one from the larger institutional structures designated to supervise activity of financial institutions in Lithuania, including the Central Bank of Lithuania, FCIS (Financial Crime Investigation Service), Snoras auditing company Ernst and Young Baltic, and others, blew the whistle.

1.1. “ERNST & YOUNG BALTIC” RESPONSIBILITY FOR SNORAS BANKRUPTCY

In the fourth quarter of 2011 then the largest Lithuanian domestic bank, the third largest bank by deposits and the fifth by assets, Snoras, became insolvent due to alleged fraud and misappropriation of assets.

Suspiscions of fraud and money laundering came to light as the Bank of Lithuania sought to verify the value of some financial assets that Snoras reportedly held abroad, but which appeared to be missing. While investigations are ongoing, some preliminary findings are that (i) various assets recorded in Snoras’ balance sheet had been transferred out of Snoras ownership; (ii) Snoras’ assets had been provided to other banks as collateral for loans to companies allegedly related to key individuals related to Snoras (this collateral was called upon at the time Snoras entered bankruptcy, causing significant loss); and (iii) certain assets had been purchased at above market value from companies allegedly related to key individuals related to Snoras, thereby overstating the value on Snoras’ balance sheet.10

On 7th December 2011, the bankruptcy administrator adjusted Snoras’ financial information and concluded that the fair value of the bank’s assets is approximately € 1.2 billion less than it was [previously] stated, and that therefore the bank is insolvent.

The authorities considered several restructuring options, and even passed additional legislation in December 2011 to allow for a good bank-bad bank approach. However, in the light of the criminal allegations facing the bank, and the authorities’ assessment that a merger or P&A11 would unlikely be successful

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9 International Monetary Fund, supra note 5: 6.
10 International Monetary Fund, supra note 5: 36.
11 Purchase and Assumption – “A resolution method in which a healthy insured institution purchases some or all of the assets and assumes the deposit liabilities of a failed bank or thrift”//
especially not under the given time constraint, the authorities chose liquidation.\textsuperscript{12}

The appointed bankruptcy administrator Neil Cooper stated that:

The failure of Snoras was the largest insolvency event ever seen in Lithuania and it has had a significant impact on many of its customers and counterparties in Lithuania and internationally. As well as being a significant Lithuanian bank, the major assets and liabilities of Snoras were international, making the bankruptcy a complex multi-jurisdictional matter.\textsuperscript{13}

In addition, “the vast geographical spread of creditors, operations and potentially recoverable assets means that this is a truly international bankruptcy case of considerable scale.”\textsuperscript{14}

On 7 December 2011, the Regional Court of Vilnius initiated a bankruptcy case for AB Snoras bank. After lengthy judicial proceedings the bank was declared bankrupt by the Court in August 2012. The bank’s principal owners became suspects in a criminal case by The Prosecutor General’s Office of Lithuania (the Prosecutor General) for the following alleged offences: “(i) Misappropriation of Property (Article 183(2) of the Lithuanian Penal Code (the Code)), (ii) Forgery of a Document or Disposal of a Document (Article 300 of the Code), (iii) Fraudulent Accounting (Article 222(1) of the Code), (iv) Abuse of Office (Article 228(2) of the Code).”\textsuperscript{15}

“Ernst &Young Baltic” (EYB) was an external auditor of the bank and carried out the audit of its financial statements of 2010. Less than a year before the collapse, in March 2011, EYB released an unqualified auditor’s opinion on Snoras financial statements. By releasing an unqualified (clean) opinion the auditor confirmed that the financial statements of the audited entity are presented fairly in conformity with accepted accounting principles, relevant statutory regulations and that the auditor has no significant reservations concerning audited financial statements. After the real situation of Snoras came to light the Audit Committee of the Parliament of the Republic of Lithuania issued a decision, by which the Authority of Audit and Accounting (Audit Authority) had to investigate the audit of Snoras financial statements of 2010 executed by EYB.\textsuperscript{16} In June 2012, after the

\textsuperscript{12} International Monetary Fund, supra note 5: 37.
\textsuperscript{15} The Prosecutor-General’s Office Of Lithuania Requesting Judicial Authority v. (1) Vladimir Antonov (2) Raimondas Baranauscas Requested Persons, The Westminster Magistrates’ Court (2014).
investigation, the Audit Authority found out that the auditor R. Bartašius, who was assigned to perform the audit, violated both the Law on Audit of the Republic of Lithuania (Article 27(3-1)) and the International Standards on Auditing (ISAs) (Standard 200 (3)), by failing to collect sufficient audit evidence in order to reduce auditing risks to an acceptably low level and by lacking professional skepticism. Therefore, the auditor released an unqualified audit opinion unreasonably. The Audit Authority imposed disciplinary penalties on the audit company and the auditor himself by ordering EYB to improve its auditing controls and cancelling the auditors' license of the EYB employee.\textsuperscript{17} It was emphasized that EYB performed the audit of public interest entity and therefore the disciplinary penalty was imposed according to the scale of harm to public interest. The Audit Authority's report was considered to be a path for future litigation against EYB.

In October 2012, the Prosecutor General announced that after the examination of Snoras audit report of 2010 executed by EYB it opens a pre-trial investigation of EYB alleged failure to perform official duties (The Lithuanian Penal Code, Article 229):

\begin{quote}
A civil servant or a person equivalent thereto who fails to perform his duties through negligence or performs them inappropriately, where this incurs major damage to the State, a legal or natural person, shall be punished by deprivation of the right to be employed in a certain position or to engage in a certain type of activities or by fine or by arrest or by imprisonment for a term of up to two years.\textsuperscript{18}
\end{quote}

It was stated that the audit had significant deficiencies and a pre-trial investigation of the case was assigned to Vilnius Board of the Special Investigation Service. EYB maintained the position that the audit complied with relevant auditing standards. EYB and the auditor appealed the Audit Authority's decision to impose a disciplinary penalty.

In April 2014, The Supreme Administrative Court of Lithuania made a final judgment in a case, where the plaintiffs EYB and R. Bartašius appealed the decision to impose a disciplinary penalty to the plaintiffs made by a defendant - the Authority of Audit and Accounting. The appeal by EYB and R. Bartašius was dismissed. The judgment of Vilnius Regional Administrative Court was affirmed.\textsuperscript{19}

The Supreme Administrative Court emphasized that:

\textsuperscript{17} The Authority of Audit and Accounting, ”Press release on the results of the investigation of statutory audits of Snoras bank” (2012) // http://www.aat.lt/index.php?id=1034 statement.
\textsuperscript{18} The Lithuanian Penal Code (2000 09 26, No. VIII-1968), Article 229.
The auditor's opinion cannot be based on presumptions. The auditor must know the aims, the objectives, and the professional ethics principles provided in the Law on Audit. Also, the auditor must be familiar with the fact that a very wide range of stakeholders (credit and government institutions, investors, etc.) rely on his reporting. ... The aim of the audit is to assure the foreseeable stakeholders of credibility and reliability of the audited financial statements.20

The Court also affirmed that in this particular case the audited entity was one of public interest, hence by releasing an unreasonably unqualified auditor's opinion the auditor caused harm to the public interest as well as misled various stakeholders. Consequently, a judicial panel considering that the auditor of public interest entity must perform the audit according to special requirements set out in the Law of Audit (Articles 51-54), also, considering the auditor's violations, e.g. deviation from professional skepticism principle and unreasonable release of unqualified opinion, concluded that audit quality weaknesses were reasonably evaluated as significant, therefore the disciplinary penalty (according to the Law on Audit Article 39(2) to take a decision to indicate the Chamber of Auditors to cancel the title of the auditor;) was imposed reasonably. Furthermore, a judicial panel maintained that EYB violated International Quality Control Standard (Articles 45, 46) by allowing additional document being placed in audit report after the report was completed, consequently, the disciplinary penalty — correct deficiencies in the auditing control system — imposed by the Audit Authority to EYB was reasonable.21 In October 2014, Snoras (in bankruptcy administration) and EYB signed a settlement agreement resolving the disputes related to Snoras audits prior its bankruptcy:

As part of this settlement EYB has agreed to pay 40,000,000 LTL into the bankruptcy estate. The parties are pleased to have the matter resolved amicably and in a manner that is mutually beneficial to both parties and Snoras' creditors. The settlement has concluded without any admissions of responsibility by either party and recognizes the commercial benefits in bringing this matter to a close.22

After the settlement EYB became one of the defendants in another lawsuit. The plaintiffs, clients of Snoras bank (446 individuals in total), filed a claim to the Vilnius Regional Court asking for compensation jointly from the defendants BAB bank Snoras, The Republic of Lithuania, Bank of Lithuania, shareholders of the bank R.B. and V.A., and "Ernst & Young Baltic" UAB. The plaintiffs specified that the

20 Ibid.
21 Ibid.
defendant EYB influenced their decision to entrust their funds specifically to Snoras bank, by issuing audit reports with significant deficiencies.\textsuperscript{23} The case is ongoing.

Finally, in July 2015, Prosecutor General's Office of the Republic of Lithuania division of Organized Crime and Corruption Investigation referred a case to the court, where a former employee of EYB – R. Bartasišius – has allegedly failed to perform official duties.

After the comprehensive investigation carried out by Vilnius Board of the Special Investigation Service the former auditor was charged with failure to perform official duties. The findings of the case suggest that the auditor failed to follow the Law on Audit as well as International Standards on Auditing, while performing the audit of Snoras financial statements of 2010. Consequently, by releasing auditor’s opinion the auditor misled the Bank of Lithuania, government institutions, legal and natural persons about the financial situation of the bank, also, the auditor contributed to the creation of false illusion of safe investments in Snoras bank, hereby greatly harming the government, depositors and creditors of the bank.\textsuperscript{24}

The case is ongoing.

To conclude, the collapse of Snoras bank was the largest bankruptcy case in Lithuania. The failure to fulfil a public role by the bank's auditors was especially significant, considering that the principal owners of the bank faced criminal charges for alleged fraudulent accounting, meaning that the auditor not only failed to inform the public about the accurate financial risks, but also overlooked indications of fraud and money laundering by releasing an unreasonably unqualified auditor's opinion.

\textbf{1.2. DELOITTE’S ROLE IN ŪKIO BANKAS INSOLVENCY}

In the beginning of 2013, after the inspection of AB Ūkio bankas, the Bank of Lithuania determined that the bank was de facto insolvent. At the time it was the fourth largest bank in Lithuania, by deposits having 7.2 \% of the market. “The lender’s liabilities exceeded its assets by 1.2 billion LTL as of March 18, [2013].”\textsuperscript{25}

According to the Bank of Lithuania:


Independent auditors conducted valuation of the Bank’s assets and identified significant mismatches in the real value of the assets. Major problems of AB Ūkio bankas are related with irresponsible actions of its main shareholder, financing of business projects related to him, and not implemented business projects. ... In view of these circumstances, the Board of the Bank of Lithuania declared a moratorium of the bank activities on 12 February 2013, appointed a temporary administrator and six days later announced de jure the bank as insolvent and revoked its banking license. ... Under the proposed plan, the good part of the Bank’s assets and all insured liabilities would be transferred to another, already operating bank, whereas for the other part bankruptcy proceedings would be initiated.26

In May 2013, the Kaunas Regional Court initiated a bankruptcy case for AB Ūkio bankas.

On 27 February 2013, the Audit Committee of the Seimas of the Republic of Lithuania asked the Audit Authority to investigate the audit of AB Ūkio bankas performed by UAB "Deloitte Lietuva" (Deloitte). While the Audit Authority conducted its investigation, the main shareholder of Ūkio bankas became a suspect in a criminal case for allegedly embezzling significant amount of funds from the bank.27

In August 2013, an international arrest warrant was issued for Vladimir Romanov; however, Russia has granted asylum to the banker and has refused to extradite him to Lithuania. In July 2014, the court declared the bank bankrupt and ordered liquidation. At the same time the Audit Authority concluded its investigation and disclosed that Deloitte's audit has significant quality deficiencies:

During the investigation it was determined that auditor S. Babarskas violated the Law on Audit (Article 27 (3)) by failing to perform the audit of AB Ūkio bankas financial statements of 2011 according to International Standards on Auditing. The auditor violated ISAs (Standard 200) ‘Quality Control for an Audit of Financial Statements’ by not performing any mandatory procedures required in the Standard except signing the auditor's opinion. Thus, the auditor failed to follow Integrity and Professional Competence and Due Care standards set out in the Code of Ethics for Professional Accountants by releasing auditor's opinion on AB Ūkio bankas financial statements of 2011 without performing the audit of these statements according to the Law on Audit, professional standards and the Code of Ethics for Professional Accountants.28

Furthermore, the Audit authority affirmed that UAB "Deloitte Lietuva" violated the Law on Audit (Article 29(3)) by not complying with International Standard on

Quality Control 1 (Article 11b) stating that “The objective of the firm is to establish and maintain a system of quality control to provide it with reasonable assurance that reports issued by the firm or engagement partners are appropriate in the circumstances” 29. According to the Audit Authority the auditor unreasonably released an unqualified audit opinion. The Audit Authority emphasized that AB Ūkio bankas was a public interest entity, “which is of significant public relevance, because of its size, nature of business and number of stakeholders” 30; therefore the audit deficiencies discovered during the investigation had a significant impact on the bank's stakeholders and users of financial information. Consequently, the Audit Authority imposed disciplinary penalties both to the auditor and the audit company. According to the Law on Audit (Article 39 (2-1)) the Audit authority indicated the Chamber of Auditors move to cancel the title of auditor S. Barbaskas and according to the Law on Audit (Article 39 (1-1)) issued a warning to Deloitte. 31

The auditor appealed to the Vilnius Regional Administrative Court asking to suspend the disciplinary penalty imposed by the Audit Authority for a period of a trial. The Court ruled in the auditor's favor. The Audit Authority appealed to the Supreme Administrative Court asking to reverse the previous Court decision. The Court emphasized that the purpose for implementing disciplinary penalty is to deprive a person from a right to be employed as an auditor for a certain period of time. After three years the person has a right to retake auditor's exam. The Court explained that if the disciplinary penalty would be suspended for a period of a trial, the whole purpose of the disciplinary penalty could be undermined in case the trial lasts three years or more throughout which the auditor keeps its title and after the trial is over can retake the exam despite the verdict. Furthermore, the court confirmed that the auditor's arguments for suspending the disciplinary penalty related to the possibility of future financial loss are not relevant in this case and are not consistent with the practice of Lithuanian courts; therefore, the decision of Vilnius Regional Administrative Court was reversed. 32

Kaunas Regional Court has accepted a claim (case no. 2-1088-773/2016 33) where plaintiff BAB Ūkio bankas (in bankruptcy) represented by bankruptcy administrator is asking for compensation from the defendants UAB “Deloitte

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30 The Authority of Audit and Accounting, supra note 28.
31 The Authority of Audit and Accounting, supra note 28.
Lietuva”, Deloitte advisory s.r.o., Deloitte Central Europe Holding Limited and Deloitte Touche Tohmatsu Limited. The plaintiff argues that the defendants violated applicable regulations by not detecting irregularities in Ůkio bankas financial statements while performing statutory audits of Ůkio Bankas from 2007 until 2011. The plaintiff claims that due to auditors’ violations the bank has incurred direct losses (because of faulty audits the bank has increased its liabilities) and indirect losses (due to increased liabilities the bank's ability to meet creditors’ claims decreased). The case is ongoing.

1.3. DISCUSSION OF THE CASES

The analysis of legal actions against auditors following collapses of both Snoras and Ůkio bankas highlights not only the shortcomings in audit market regulation, but also problems of auditors’ civil liability. Banks, considering their important role in sustainability of economy, are deemed public-interest entities (PIE), so in both cases analysed here the core issue was the auditors' failure to fulfil their public role. The Supreme Administrative Court of Lithuania argued that auditors must know that a very wide range of stakeholders rely on their reporting and by releasing faulty reports auditors harm the public interest.34 Consequently, the auditors were held liable for malpractice as the Audit Authority imposed disciplinary penalties on both audit companies and cancelled the titles of statutory auditors responsible for the audits performed. Both audit companies are defendants in ongoing civil litigations, and the statutory auditor of Snoras bank faces criminal charges for alleged failure to perform official duties. The auditors' failure to fulfil their public role highlighted the need for more coherent audit quality and transparency requirements. According to the authors of MARC Response to EC Consultation:

Audit failures are typically associated with two distinct circumstances: (1) the auditor does not deliver the implicit audit quality set by auditing standards and regulations, or (2) the auditor has complied with auditing standards and regulation but the audit quality achieved during the course of the audit fails to reveal all material misstatements in the financial statements. ... Further, to the extent that these issues should be addressed with regulations, the implications for what those regulations should be, may be quite different. For example, (1) may be addressed with better rules safeguarding auditor independence, possibly

34 UAB “Ernst & Young Baltic” and R. B. v the Authority of Audit and Accounting, supra note 19.
with stricter monitoring and enforcement, while (2) potentially requires improved audit processes and, possibly, new auditing standards.\(^{35}\)

In the cases of Snoras and Ūkio bankas the principal shareholders of the banks confronted criminal charges for alleged fraud; therefore, the auditors not only failed to inform the investing public about the accurate financial risks, but also overlooked indications for alleged criminal activity. Auditors are considered to be professionals for whom a high standard of care is applicable. It means that the slightest fault, mistake or failure to comport to professional rules and standards shall lead to liability for malpractice. A high standard of care for professionals was repeatedly stated by Lithuanian Supreme Court in malpractice cases of professionals (doctors, lawyers, notaries, banks, etc.)\(^{36}\).

Law on Audit sets a high standard for auditors’ performance.\(^{37}\) The statutory auditor is obliged to act in accordance with specific requirements for his profession while performing his duties. Intentional or unintentional violation of Standards on Auditing, or any of the principles of professional ethics as well as negligence in any degree, indicates unlawfulness. In both cases the auditors violated the law on Audit as well as failed to follow standards of professional ethics. Art 6.246(1) CC describes unlawfulness as follows: civil liability shall arise from the non-performance of a statutory or contractual duty (unlawful omission), or from the performance of actions that are prohibited by laws or a contract (unlawful acts), or from violation of the general duty to behave with due care. Also, in order to establish whether or not the auditor acted negligently, an objective yardstick referring to the *bonus pater familias*\(^{38}\) is applied. The conduct of persons engaged in professional activities, which require special skills, training or/and experience, such as doctors, lawyers, notaries, bankers, etc., is measured against the standards of reasonably skilled members of the same professional group. For example, in a case where statutory auditor of Snoras bank and EYB appealed to the

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\(^{35}\) Rogier Deumes, Robert Knechel, Roger Meuwissen, Caren Schelleman, and Ann Vanstraelen, *supra* note 1, 3

\(^{36}\) For example, in case of UAB ‘Stagena’ v AB SEB bank and GS, the plaintiff, the company in the bankruptcy procedure, represented by its’ bankruptcy administrator, filed a claim against its former executive and SEB bank, alleging them with unreasonable real estate acquisition transactions which were financed by the SEB bank and, according to the plaintiff, drove the company to insolvency and consequently to bankruptcy, causing considerable damage to the creditors of the company. The LSC asserted that tortious liability of a bank or other credit institution for financing services may be established when the interests of third parties are infringed, however only if the conduct of the bank issuing credit clearly derogates from the standard of a reasonable banker (*UAB ‘Stagena’ v AB SEB bank and GS*, The Supreme Court of Lithuania, Civil Case No. 3K-3-420/2013 (2013)).

\(^{37}\) For example, Article 27 (3) of the Law on Audit states that the auditor must: 1) when carrying out audit comply with laws and other legal acts, the International Auditing Standards (ISAs); 2) abide by principles of professional ethics laid down in the Code of Ethics of Professional Accountants; Additionally, Article 4 of the Law on Audit sets forth mandatory principles of professional ethics: 1) independence and objectivity; 2) confidentiality and professional secrecy; 3) integrity; 4) professional competence and due diligence; 5) social responsibility.

\(^{38}\) The term *bonus pater familias* (good family father) refers to a standard of care, analogous to that of the reasonable man.
Audit Authority’s decision to impose disciplinary penalties the Supreme Administrative Court of Lithuania indicated that auditor lacked professional skepticism and based his opinion on presumptions.\textsuperscript{39}

In Lithuania, as well as in a majority of the Member States, auditors’ civil liability is unlimited. An auditor may be liable for malpractice in a lawsuit brought by its direct client or third parties. These claims, especially if brought by the third parties as a matter of fact, are based on tort.\textsuperscript{40} The Supreme Administrative Court of Lithuania emphasizes auditors’ responsibility to third parties stating that “releasing of unreasonably unqualified auditors’ opinion of public interest entity itself violates public interest and misleads consumers of financial statements information.”\textsuperscript{41} Tortious liability of auditors by nature is not strict. Only in case of strict liability is fault not the prerequisite of liability. It means that all four conditions for liability shall be present: damage, unlawfulness, causation and fault. According to art 6.248(1) CC, the fault of the debtor is presumed, so in auditors’ malpractice cases fault is presumed.\textsuperscript{42} We already discussed high standard of care as prerequisite of unlawfulness in malpractice cases of professionals. With regards [to] damages, it should be also mentioned that interests of pure economic nature\textsuperscript{43} in Lithuanian doctrine and case law deserve lower protection of tort law. Auditors, depending on the claim, can be found liable jointly and severally together with other defendants against claims of clients or third parties.

In terms of audit market regulation, auditors’ independence, civil liability insurance and disciplinary penalties issues to some extent were found in both collapses of Snoras and Ūkio bankas. For example, in terms of auditors’ independence, Deloitte was auditor of Ūkio bankas for more than 10 years and had a contract for the following year and the statutory auditor of Snoras bank allegedly had conflict of interest by keeping significant amounts of money in his personal account in Snoras bank at the time of audit.\textsuperscript{44} However, the audit market for financial institutions in Lithuania as well as in other countries is concentrated in [the] hands of [a] few international audit companies. This concentration creates additional problems, which are discussed in the second section of this paper.

\textsuperscript{39} UAB “Ernst & Young Baltic” and R. B. v the Authority of Audit and Accounting, supra note 19.


\textsuperscript{41} UAB “Ernst & Young Baltic” and R. B. v the Authority of Audit and Accounting, supra note 19.

\textsuperscript{42} The concept ‘debtor’ in the CC includes both the contractual debtor and the tortfeasor.

\textsuperscript{43} For example such as loss of income from in due time not returned bank deposit.

In Lithuania as well as in a majority of EU Member States, civil liability insurance of firms of auditors is mandatory. Article 20 of the Law on Audit states that:

When the object of compulsory civil liability insurance is civil liability of the audit firm for damage which would have been caused to the contractor and/or third persons when carrying out audits in public interest entities, the minimum annual sum of civil liability insurance must amount to at least LTL 200,000 [€ 57 924] per one insured event and LTL 500 000 [€ 144 810] for all insured events.46

Considering the amount of the settlement in the Snoras case and the amounts of claims in ongoing lawsuits for malpractice, it is evident that mandatory insurance cannot manage liability risks of auditors of banks.47

Also, after analysis, it is evident that there are no intermediate disciplinary penalties available to the Audit Authority. According to Article 39 of the Law on Audit, the Audit Authority can issue a warning to an audit firm or cancel its certificate. There is no possibility to impose administrative fines, which could fill the gap between formal warning and the extreme sanction of cancelling an audit firm’s certificate. In addition, Article 30a (f) of the Directive 2014/56/EU on Statutory Audits of Annual Accounts and Consolidated Accounts names the imposition of administrative pecuniary sanctions on natural and legal persons as one of “administrative measures and sanctions for breaches of the provisions of the Directive and, where applicable, of Regulation (EU) No 537/2014”48; therefore, such extension of the Audit Authority’s powers would be in accordance with the Directive.

In conclusion, the analysis of legal actions against the auditors in the Snoras and Ūkio bankas bankruptcies identified not only the auditors' failure to fulfil their public role, but also highlighted the need for more coherent audit quality and transparency requirements, improved auditors' accountability and supervision procedures, strengthened auditors' independence regime, as well as shortcomings of auditors’ civil liability insurance and disciplinary and civil liability regulation.

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45 Annex II to the Commission Staff Working Paper, supra note 40: 15.
47 See for further discussion on issue of insurance in part 2.2.
2. CALL FOR CHANGE

2.1. REFORM IN EUROPEAN LEGAL FRAMEWORK ON AUDIT REGULATION

In order to prevent the history of the financial institutions’ crisis from repeating itself, the EC has initiated reform of the audit market. A new legislation, Directive 2014/56/EU on statutory audits of annual accounts and consolidated accounts and Regulation EU (No) 537/2014 on specific requirements regarding statutory audit of public-interest entities (PIEs) became applicable beginning in June 2016.

EU reform of audit market introduces measures which aim to increase quality and transparency of statutory audits. First, Article 10 of Regulation EU (No) 537/2014 on specific requirements regarding statutory audits of public-interest entities sets out detailed requirements for the audit report of public interest entity. “Regulation introduces a requirement for statutory auditors auditing PIEs to report on key areas of risk of material misstatement of the annual or consolidated financial statements. In addition, statutory auditors will need to explain to what extent the statutory audit was considered capable of detecting irregularities, including fraud.”

Second, Article 8 of the Regulation introduces an engagement quality control mechanism, which “shall be performed to assess whether the statutory auditor or the key audit partner could reasonably have come to the opinion and conclusions expressed in the draft of these reports. ... The reviewer shall be a statutory auditor who is not involved in the performance of the statutory audit to which the review relates.” Moreover, the adoption of ISAs is named as a means to increase quality of statutory audits. “The research has shown that an adoption of the clarified ISAs through the EU would contribute to the credibility and quality of financial statements and to audit quality in the EU, and to a greater acceptance of audit reports outside of their home jurisdictions within and outside of the EU.”

While Lithuania has formally adopted ISAs, they are still not mandatory across the EU. Regulation empowers the EC to adopt ISAs within the Union; however, there is yet no schedule for the adoption.

Accountability of auditors is another area of concern in audit market regulation. The EC addresses this issue by proposing to strengthen the role of the

49 European Commission, supra note 2.
audit committee. The main measures include Article 11 of the Regulation, which introduces the requirement of additional report to the audit committee of the audited entity.

The additional report aims to increase further audit quality and avoid any loopholes, via enhanced communication between the statutory auditor or the audit firm on the one hand, and the entity's audit committee on the other hand. The additional report will provide the audited PIE with more detailed information on the outcome of the statutory audit, including for instance on the methodology used, on possible significant deficiencies identified in the internal control system, on the valuation methods applied, etc.\textsuperscript{52}

This report is designated for the audit committee; however, Member states have a right to make this report available for third parties if that complies with their national law. Also, in the Directive 2014/56/EU there are "new rules that introduce the possibility for 5\% of the shareholders of a company to initiate actions to dismiss the auditors."\textsuperscript{53}

Another major issue in audit market regulation and in some instances the cause of inadequate audit report is auditors' independence. "An excessive familiarity between management of a company and its audit firm, risks of conflicts of interest, and threats to the independence of statutory auditors can challenge the ability of statutory auditor to exert through professional skepticism."\textsuperscript{54} In EU audit market reform (1) Mandatory rotation of audit firms of PIEs, (2) Prohibition of certain non-audit services to audited PIEs, and (3) Cap on the provision of non-audit services to PIEs, are named as the key measures to strengthen auditors' independence regime.\textsuperscript{55} While explaining the importance of auditors' rotation requirement EC states that:

There are obvious risks for PIEs in having the same statutory auditors or audit firms for 50 or 100 years as happens today. ... Mandatory audit firm rotation will help reduce excessive familiarity between the statutory auditor and its clients, limit the risks of carrying over repeated inaccuracies, and encourage fresh thinking, thus strengthening the conditions for genuine professional skepticism.\textsuperscript{56}

In Regulation (EU) No 537/2014 a new requirement of mandatory audit firm rotation is introduced: "A public-interest entity shall appoint a statutory auditor or an audit firm for an initial engagement of at least one year. The engagement may

\textsuperscript{53} Ibid.
\textsuperscript{54} Ibid.
\textsuperscript{55} Ibid.
\textsuperscript{56} European Commission, supra note 3.
be renewed. Neither the initial engagement of a particular statutory auditor or audit firm, nor this combination with any renewed engagements there with shall exceed a maximum duration of 10 years.\textsuperscript{57} However, there are exceptions which allow for the extension of the maximum term to 20 years on the condition that a public tender is undertaken after 10 years, and the extension to the maximum term of 24 years is allowed if a joint audit is carried out.\textsuperscript{58} However, even if auditors’ independence issues were found in both collapses of Snoras and Ūkio bankas, because of audit market concentration in hands of few players and risk of catastrophic claim and limited civil liability insurance\textsuperscript{59}, effectiveness of this measure is limited.

Other measures that are targeted at strengthening auditors’ independence are prohibition of providing certain non-audit services to audited entity and a cap on the provision of non-audit services to PIEs. Article 5 of Regulation (EU) No 537/2014 specifies services which cannot be provided by auditors of PIEs, these include tax advice services, risk management procedures, valuation and investment strategy related services, and services related to human resources and audited entity’s internal audit function.\textsuperscript{60} “The aim is to limit risk of conflicts of interest, when statutory auditors are involved in the making of decisions impacting the management of the PIEs they audit. This will also substantially limit the likelihood that statutory auditors self-review their recommendations.”\textsuperscript{61}

As it was already mentioned, analysis of auditors’ roles in Snoras and Ūkio bankas also identified auditors’ failure to fulfil their public role, Directive 2014/56/EU and Regulation (EU) No 537/2014 intend to clarify auditors’ public role throughout increasing quality of statutory audits, enhancing transparency of audit process, and strengthening the role of audit committees; therefore the measures proposed by European Commission seem reasonable in given circumstances. Since auditors’ independence risks are related to human factors (i.e. over familiarity), limiting auditors' possibility to provide certain non-audit services to audited entities and introducing requirement of mandatory rotation of audit firms should help strengthening auditors' independence vis-à-vis their clients.

Nonetheless, in the initial proposal for the Regulation by the EC the maximum term for mandatory rotation was 6 years with a possibility of extension to 12 years. In the adopted Regulation the maximum terms for mandatory rotation are accordingly 10 years and 24 years. Considering the Commission’s arguments of the importance of mandatory rotation as well as auditors’ independence issues in

\textsuperscript{57} Regulation EU No 537/2014, supra note 50, Article 17-1.
\textsuperscript{58} Ibid., Article 17-4 a, b.
\textsuperscript{59} See for further discussion in section 2.2.
\textsuperscript{60} Regulation EU No 537/2014, supra note 50, Article 5.
\textsuperscript{61} European Commission, supra note 3.
Snoras and Ūkio bankas cases, it is uncertain whether having a mandatory rotation every two decades would actually prevent statutory auditors from close association with the management of audited entity. Therefore, further limitation of rotation terms is recommended.

It is evident that EU audit market reform brings positive changes in audit market regulation and supervision. However, it is critical that these changes would be followed by a shift in culture of financial institutions.

Because the behavior of the financial sector has not changed fundamentally in a number of dimensions since the crisis — the idea that private misbehavior can have a broader social cost—is only in its early stages. ... To restore trust, we need a shift toward greater integrity and accountability. We need a stronger and systematic ethical dimension. Getting back on the right path requires education and leadership that is sustained over many years. It requires alert watchdogs, including from civil society. Most importantly of all, it requires investors and financial leaders taking values as seriously as valuation, culture as seriously as capital.  

2.2. PROBLEM OF AUDITORS CIVIL LIABILITY

While the new EU Audit Directive and Regulation addresses problems related to insufficient audit quality and transparency, the auditors’ liability issue is excluded from the reform. In most member states the liability of auditors is unlimited. The core argument for having unlimited auditors’ liability is the importance of the public-interest function of statutory audit. However, having unlimited auditors’ liability system is seen as potentially dangerous situation because of specific economic circumstances of statutory audit market.

After in-depth research and extensive consultation, we have concluded that unlimited liability combined with insufficient insurance cover is no longer tenable. It is a potentially huge problem for our capital markets and for auditors working on an international scale. The current conditions are not only preventing the entry of new players in the international audit market, but are also threatening existing firms.

According to the EC, the main problems related to unlimited auditors’ liability are audit market concentration and lack of appropriate insurance for auditors and audit companies.

The statutory audit market of public interest entities is dominated by four major audit companies: Deloitte, Ernst & Young, KPMG, and PwC – “the Big-4”. The

62 Christine Lagarde, supra note 4.
situation when one of the Big-4 collapses could be highly damaging to financial institutions, because of the complexity of their activities only the Big-4 companies have the resources to carry out statutory audits of these entities.

The limited number of players might shrink further for different reasons. The Big 4 assert that a catastrophic claim could lead to the collapse of one of them. Another risk might be that major audit firms could implode due to an immediate loss of confidence and reputation by client companies who become aware of a major audit failure by an individual audit partner inside the international network as is commonly held to be the reason for the collapse of Arthur Andersen in 2002. The third risk might be an indictment or removal from a register in a major country harming the brand of entire network.64

While “the Big-3” scenario is possible, a middle-tier firm entering the Big-4 market is unlikely. "Middle-tier firms face a number of barriers to entry into the market. Such barriers are reputation, capacity and breadth of their networks, and the exposure to unlimited liability in most Member States combined with very limited professional insurance availability."65 Risks associated with professionals’ liability are usually managed by professionals’ indemnity insurance. Notwithstanding, statutory auditors of financial institutions are unable to access sufficient insurance coverage. Ingrid De Poorter argues that

Due to the increased market capitalization of companies during the last decade, the risk of auditing such companies has increased similarly. At the same time, access to insurance for auditors has fallen sharply, especially for firms auditing international and listed companies, thus leaving partners in audit firms with an unattractive prospect of entirely supporting the liability risks themselves.66

A study by London Economics found that:

The current level of commercial insurance is such that it would cover less than 5% of the larger claims some firms face nowadays in some EU Member States. ... Once a firm has exhausted the limited cover provided by the network's captive and commercial insurers, the remaining source of funds is essentially the partners' income. At issue then for a firm is how large an income cut partners would be willing to take before leaving the firm in drove, resulting in the collapse of the firm.67

67 London Economics in association with Professor Ralf Ewert, supra note 65.
As previously mentioned, in Lithuania as well as in a majority of the EU Member States civil liability insurance of firms of auditors is mandatory. But, considering the amounts of settlements in lawsuits filed against audit companies for malpractice during and after the Global financial crisis of 2008, it is evident that mandatory insurance cannot manage liability risks of statutory auditors of financial institutions.

Insurance capacity might be possible, even for high sums, if the liability situation is clear and the price is appropriate. But in the case of auditors, due to the long tail exposure of the underwritten risk (i.e. the risk of a claim can exist for many years after the audit was carried out), insurers would have to provide an extremely long commitment of equity. Although the number of claims is low, the severity of the settlement is very high. ... Given these characteristics, insurers have difficulty in pricing audit liability risk, and, hence in providing adequate insurance coverage.69

Moreover, in cases of joint and several liability plaintiffs can use audit companies as an insurance against any deficiencies in companies’ financial statements. According to a study carried out by London Economics:

In a regime of joint and several liability, any statutory audit liability limitation will help address the 'deep pocket' syndrome whereby the audit firm is typically viewed by plaintiffs as having the largest resources and is therefore the target of complaints irrespective of the contribution and responsibility of the firm to the event giving rise to the complaint.70

Despite the arguments for unlimited auditors' liability because of the importance of public interest function of statutory audit, the European Commission sees unlimited liability of auditors as a problematic issue and has presented a Recommendation 2008/473/EC concerning the limitation of the civil liability of statutory auditors and audit firms. The Recommendation does not justify any limitations in case of intentional breach of professional duties by auditors. In the Recommendation, due to significant differences in civil liability systems of the Member States, the Commission proposes several options for limiting statutory auditors' liability:

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70 London Economics in association with Professor Ralf Ewert, supra note 65.
(a) Establishment of a maximum financial amount or of a formula allowing for the calculation of such an amount; (b) establishment of a set of principles by virtue of which a statutory auditor or an audit firm is not liable beyond its actual contribution to the loss suffered by a claimant and is accordingly not jointly and severally liable with other wrongdoers; (c) provision allowing any company to be audited and the statutory auditor or audit firm to determine a limitation of liability in an agreement.\textsuperscript{71}

However, this Recommendation is non-binding; therefore, in Lithuania no changes in statutory auditors’ liability system have been made. Also, there have not been any binding documents concerning limiting civil liability of statutory auditors in the EU issued yet.

\textbf{CONCLUSIONS}

1. Because the banking sector is considered one of the most important and sensitive sectors of the economy, it is pivotal to maintain public confidence in the banking system. Hence, auditors must understand the complexity of their activities, as well as the risk exposures, and know that a very wide range of stakeholders rely on their reporting; thus, by releasing faulty reports, auditors harm the public interest.

2. Case analysis of legal procedures against auditors in the Snoras and Ūkio bankas bank ruptcies highlighted the need for more coherent audit quality and transparency requirements, improved auditors’ accountability and supervision procedures, strengthened auditors’ independence regime, as well as shortcomings of auditors’ civil liability insurance and disciplinary and civil liability regulation.

3. The new European legal framework on audit regulation intends to clarify auditors’ public role throughout increasing quality of statutory audits, enhancing transparency of audit process, and strengthening the role of audit committees. It also introduces mandatory rotation with a maximum term of 10 years, with a possibility of extension to 24 years. However, having in mind the auditors’ independence issues in Snoras and Ūkio bankas cases, it is uncertain whether having a mandatory rotation every two decades would actually prevent statutory auditors from close association with the management of audited entity. Thus, it is critical that changes of legal regulation would be followed by a shift in the culture of financial institutions.

4. The auditors’ liability issue is excluded from the reform. In most member states liability of auditors is unlimited. However, having unlimited auditors’

\textsuperscript{71} Commission Recommendation of 5 June 2008 concerning the limitation of the civil liability of statutory auditors and audit firms, 2008/473/EC. OJ L 162, Article 5.
liability system combined with very limited professional insurance availability is seen as potentially dangerous because the statutory audit market of financial institutions is dominated by four major audit companies: Deloitte, Ernst & Young, KPMG and PwC – "the Big-4". A collapse of one of the Big-4 could be highly damaging to financial institutions and even trigger another financial crisis.

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