



Comparative Analysis of Liability Cases for Bankruptcies of Financial Institutions

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ARTICLE INFO

Received May 12, 2017
Revised from June 21, 2017
Accepted August 23, 2017
Available online September 15, 2017

JEL classification:

G20, K40.

DOI: 10.14254/1800-5845/2017.13-3.8

Keywords:

Bankruptcy of financial institutions,
liability,
auditors,
Lehman Brothers,
Lithuanian banks and credit unions.

ABSTRACT

The bankruptcy of the fourth largest investment bank in the world Lehman Brothers Holdings Inc. in 2008 remains the largest bankruptcy in the history of United States. This bankruptcy is viewed as a turning point in the Global Financial Crisis. Paradoxically, even though the financial system had many safeguards (auditors, audit committees, the board of directors, credit rating agencies, government supervisors) whose purpose was to inform the investing public about the actual financial situation of the institution, Lehman Brothers bankruptcy came as a shock to financial markets across the globe revealing that many of the “gatekeepers” failed. Comparative analysis of liability cases after bankruptcies of Lehman Brothers and financial institutions in Lithuania shows that contrary to Lehman’s case, the demise of financial institutions in Lithuania cannot be attributed to sub-prime mortgages caused financial crisis, real estate market fluctuations or any other external variable. Problems are related to weak supervision, inefficient regulation, and common unethical behavior in the financial sector.

INTRODUCTION

The financial sector is one of the most sensitive sectors of the economy, which can normally function only with public confidence. Bankruptcies of financial institutions can spread generic panic and result in financial crisis with significant adverse effect for the economy.

The bankruptcy of the fourth largest investment bank in the world Lehman Brothers Holdings Inc. in 2008 remains the largest bankruptcy in the history of United States. This bankruptcy created shockwaves through the entire global financial system and is viewed as a turning point in the Global Financial Crisis. It indicated structural problems in regulation and supervision of financial markets as well as brought to light issues of unethical behavior in the financial sector which are relevant both in civil and common law jurisdictions. Paradoxically, even though the financial system

had many safeguards (auditors, audit committees, the board of directors, credit rating agencies, government supervisors) whose purpose was to inform the investing public about the actual financial situation of the institution, Lehman Brothers bankruptcy came as a shock to financial markets across the globe revealing that many of the “gatekeepers” failed.

After Global Financial Crisis of 2008, Lithuanian financial system was seriously shattered by insolvencies of 6 financial institutions. First, Lithuania’s banks and credit unions started collapsing beginning with Snoras bank in 2011, then in 2013 Ūkio bankas as well as credit unions Nacionalinė kredito unija and Švyturio taupomoji kasa became insolvent, and credit unions Vilniaus taupomoji kasa and Amber collapsed accordingly in 2014 and 2016. Therefore, issues related to liability for bankruptcy of financial institutions, their supervision, and prevailing ethical standards in the financial sector are especially relevant in Lithuania.

This paper analyses liability cases after bankruptcies of Lehman Brothers and financial institutions in Lithuania and compares culprits and legal grounds of liability after the aforementioned collapses of financial institutions which had devastating consequences, including loss of high-skilled jobs and deprivation of assets from both private investors and businesses, as well as diminished public trust not only in financial sector itself, but also in government institutions which ought to supervise banks and credit unions. The aim of comparative analysis is to identify structural problems in regulation and supervision of financial institutions and suggest measures that could be taken in Lithuania in order to have healthy functioning financial institutions.

Accordingly, this research consists of three parts. The first part presents the analysis of liability cases in relation to Lehman Brothers bankruptcy, focusing on auditors’ role and respective lawsuits. Also, the roles of Lehman’s officers, the Board of Directors, and credit rating agencies as well as a failure of government supervisors’ in monitoring Lehman Brothers are examined. In the second part, the liability cases after the insolvencies of banks and credit unions in Lithuania are analysed. The third part is focused on the comparison of the analyzed cases of collapsed financial entities and on identifying structural problems across jurisdictions as well as proposing certain measures which aim to improve functioning of financial institutions.

1. LIABILITY CASES AFTER THE BANKRUPTCY OF LEHMAN BROTHERS

After Lehman Brothers bankruptcy the court-appointed bankruptcy examiner Valukas issued a detailed report where the reasons of the bankruptcy were examined, as well as the parties responsible investigated.

While examining Lehman's bankruptcy, usage of Repo 105¹ is named as one of the main reasons the bank collapsed. *"In September 2000, shortly after Statement of Financial Accounting Standards 140 (SFAS 140), permitting certain repos to be treated as “sales” rather than “financings” for accounting purposes, took effect, Lehman developed a policy and program explaining how the firm might benefit from the standard. This interpretation permitted Lehman to remove from its balance sheet the securities transferred as collateral, reducing assets. The cash received was not booked as borrowings, and the obligation to repay/repurchase was not booked as an increase in liabilities. Instead, the right to repurchase the collateral was booked as a derivative right to purchase securities in the future"* (Wiggins, Bennett, & Metrick, 2015). In 2007, Lehman had to reduce its net leverage ratio, however, due to an unfavorable situation in financial markets and decreasing real estate prices, it could not sell its assets without experiencing significant losses, therefore Lehman chose to create an illusion of decreasing its net leverage ratio by expanding us-

¹ "A repurchase agreement is a transaction in which one party transfers collateral (typically securities) to another party in exchange for a short-term borrowing of cash, while simultaneously agreeing to repurchase the collateral (plus interest) at a specific time in the future. Lehman's Repo 105 transactions were repos in which Lehman transferred highly liquid and high quality securities worth at least 105 percent of the cash received." (Lehman Brothers Holdings Inc. v. Ernst & Young LLP, 2014).

age of Repo 105. According to Lehman's bankruptcy examiner Valukas (2011), "Lehman undertook \$38.6 billion, \$49.1 billion, and \$50.38 billion of Repo 105 transactions at quarter-end fourth quarter 2007, first quarter 2008 and second quarter 2008, respectively. ... I uncovered ample contemporaneous evidence that the sole purpose of these transactions was to make the published balance sheets look better than they actually were."

Not surprisingly, in the examiner's report the role of Lehman's independent auditor Ernst & Young LLP (EY) was thoroughly analyzed.

According to Lehman's bankruptcy examiner Valukas (2011), "*there is no serious dispute that Lehman's external auditor was aware of Lehman's Repo 105 accounting policy and was aware of an allegation that Lehman had used that policy to move \$50 billion temporarily off the books at quarter end.*" The fact that EY knew about Lehman's Repo 105 policy is also affirmed in the final arbitration award between EY and Lehman, where it is stated that EY had a copy of this policy.

The examiner's report was considered a path for future proceedings against Lehman and EY. EY became a respondent in two lawsuits brought against them by the aggrieved third parties and the Attorney General of New York. New York Attorney General filed a lawsuit against EY for "enabling Lehman to paint false picture of its financial statements by temporarily removing tens of billions of dollars of securities from its balance sheet without disclosing those transactions on financial statements" (Schneiderman, 2015) and EY together with Lehman's officers became respondents in Lead Plaintiffs a Third Amended Consolidated Class Action Complaint for Violations of the Federal Securities Laws.

The core issue in all lawsuits against EY was the fact that EY did not object or raised any concerns on Lehman's policy of using repurchase agreements called Repo 105. During the investigation of Lehman's bankruptcy EY maintained a position that their role was only to make sure the accounting is correct. Moreover, the auditor's position regarding Repo 105 was that "*The auditor reviewed Lehman's Repo 105 accounting policy, but not Lehman's Repo 105 practice. The auditor reviewed Lehman's Repo 105 policy "on a theoretical level." The auditor was not required to look at either the volume or timing of Lehman's Repo 105 transactions at quarter end*" (Valukas, 2011).

The bankruptcy examiner argued that EY failed in fulfilling their obligations to the public by allowing Lehman's management to hide its Repo 105 practice from the stockholders and government supervisors: "*Whether due to gaps in professional audit standards or a failure to follow those standards, the result is the same: the external auditor did not object when Lehman omitted any reference to these transactions in its public filings.*" (Valukas, 2011)

Another major issue regarding EY's obligations to the public was monitoring Lehman's liquidity pool. Despite the fact that the bank announced that it has liquidity pool of approximately \$41 billion, after five days, on September 15 of 2008, it filed for bankruptcy protection as it turned out that on September 12th it had less than \$2 billion of liquid assets, "*it literally did not have sufficient cash to open for business on Monday*" (Valukas, 2011). The bankruptcy examiner analyzed EY's position on monitoring Lehman's liquidity pool: "*Lehman's auditor stated that it was highly involved in monitoring Lehman's liquidity pool. [However] ... the auditor stated that the composition of the liquidity pool was a matter for the regulators, not the auditor. Whether or not this description of responsibility is accurate, the bottom line is that the auditor apparently did not check whether Lehman's liquidity pool was in the least bit liquid*" (Valukas, 2011).

According to Wiggins, Bennett, and Metrick (2015), "EY contended that it had done no wrong. It stood by its own opinion that Lehman's financial statements had been prepared in accordance with GAAP² and that Lehman's bankruptcy was not caused by any accounting issues. Valukas and

² GAAP - generally accepted accounting principles.

others, however, argued that determining whether the financial statements technically complied with GAAP was neither the proper standard nor the full extent of EY's duty."

In his statement before the Committee on Banking, Housing, & Urban Affairs in the United States Senate, Valukas (2011) argued that "[n]evertheless, and wholly apart from the claims involving Lehman's auditors, we must recognize the general principle that auditors serve a critical role in the proper functioning of public companies and financial markets. ... And the investing public is entitled to believe that a "clean" report from an independent auditor stands for something."

The importance of auditor's societal role is also affirmed by the fact that the auditors were the only party related to Lehman's bankruptcy, which was sued by the authorities.³

In 2013 Lehman filed a Notice of Arbitration, asserting claims for Accountant Malpractice and Breach of Contract against EY. Lehman was seeking the following damages: "(1) disgorgement of the nearly \$160 million in audit and audit-related fees it paid EY for audits and reviews of financial statements; (2) the cost Lehman incurred in entering into Repo 105 transactions in lieu of less costly repurchase transactions; and (3) the harm that Lehman Suffered as a result of business decisions that Lehman Board would have made differently had it been informed about the effects of Repo 105 on Lehman's balance sheet" (Lehman Brothers Holdings Inc. v. Ernst & Young LLP, 2014). The EY's position in arbitration was "that Lehman's malpractice and breach of contract claims are barred by fundamental principles of agency and *in pari delicto*⁴ because while the purpose and usage of the Repo 105 transactions were well known and approved at the highest levels of Lehman management, their concerns, if any, were never communicated to EY. ... any wrongdoing associated with the Repo 105 is overwhelmingly attributable to Lehman, whose management conceived of, developed and utilized the transactions" (Lehman Brothers Holdings Inc. v. Ernst & Young LLP, 2014). The law of New York has been the applicable law in this arbitration. The Panel of three arbitrators has found that "the imputation based defense of *in pari delicto* is a complete defense to Lehman's claims because any wrongdoing associated with Repo 105 is overwhelmingly attributable to Lehman" (Lehman Brothers Holdings Inc. v. Ernst & Young LLP, 2014). In conclusion, the Panel of three arbitrators in its final award found that Lehman had a claim of breach of the contract and accounting malpractice, which failed on the merits and that EY cannot be held liable to Lehman to any extent for the actions of Lehman's own management.

In addition to arbitration between Lehman and EY, there were two important lawsuits against EY, which emphasized the failure of EY fulfilling its obligations to the public. First of them, In the Lehman Brother Equity/Debt Securities Litigation (2010), where Lead Plaintiffs filed a Third Amended Consolidated Class Action Complaint for Violations of the Federal Securities Laws (under the Securities Act of 1933 and separate claims of fraud under the Securities Exchange Act of 1934) against former Lehman's officers, members of Lehman's Board of Directors and others, including Ernst & Young LLP on April 23, 2010. On October 11, 2013 EY agreed to pay \$99 million to Lead Plaintiffs in order to settle their claims (Notice of Pendency of Class Action and Proposed Settlement with Defendant Ernst & Young LLP, 2013). In addition to this, in December of 2010 the Attorney General of New York filed a lawsuit against Ernst & Young LLP under the Martin Act (securities fraud statute) and Executive Law § 63 (12) for EY's role in an alleged fraud involving Lehman's use of Repo 105, which allowed Lehman to manipulate its balance sheet and leverage ratios (The People of the State of New York, etc., v. Ernst & Young LLP, 2014). The Attorney General stated that "Auditors will be held accountable when they violate the law, just as they are supposed to hold the companies they audit accountable" (Schneiderman, 2015). On the 15th of April, 2015 the Attorney General announced that EY agreed to settle the case for \$10 million. It was emphasized that a part of the settlement will be allocated to the investors in Lehman securities alongside

³ New York Attorney General filed a lawsuit against EY for failing to inform the investing public about the exact situation of the bank.

⁴ *In pari delicto* – "a Latin term meaning "in equal fault." Refers to the principle by which a court will refrain from granting relief to a party who is equally at fault in a particular controversy as the party from whom relief is sought."// <https://www.law.cornell.edu/search/site/agency>.

with a settlement in class action lawsuit, thus that the class action lawsuit relied on facts discovered by the Attorney General of New York. According to Schneidermann (2015), "*[t]he basic duty and legal obligation of auditors is to ensure that the public companies they audit provide reliable and unbiased information about their operations to the investing public. If auditors issue opinions that are unreliable or provide cover for their clients by helping to hide material information that harms the investing public, our economy, and our country*". Finally, this Attorney General's case is of great importance, because The Appellate Division's First Department confirmed the Attorney General's power to obtain disgorgement of professional fees received by a firm, also it was the first lawsuit against an auditor of a public interest company under Securities laws of New York, and the only enforcement action initiated by authorities related to the bankruptcy of Lehman.

Lawsuits against Lehman's auditor Ernst & Young (EY) following the bankruptcy of the bank emphasized the importance of auditors' role to the healthy functioning of financial markets as well as auditor's responsibility to the public.

Financial system has many other safeguards besides auditors. The board of directors, credit rating agencies, government supervisors have the duty to inform the investing public about the actual financial situation of financial institutions. Yet, Lehman Brothers bankruptcy came as a shock to financial markets across the globe revealing that many of the "gatekeepers" failed. Therefore, it is essential to analyze responsibilities of other gatekeepers, which in Lehman's case were the managers, the board of directors, credit rating agencies, Security and Exchange Commission (SEC) and the Federal Reserve Bank of New York.

Firstly, it is clear that Lehman's chief financial officers knew about Lehman's Repo 105 program, including its volume, timing, and purpose since they were the ones carrying it out. After a year-long examination of the events which had led to Lehman's bankruptcy, the examiner found out that colorable claims of breach of fiduciary duty exist against Lehman's officers - CEO Richard Fuld and CFOs - Christopher O'Meara, Erin Callan and Ian Lowitt as well as there is a colorable claim for professional malpractice against EY "arising from Ernst & Young's failure to follow professional standards of care with respect to communications with Lehman's Audit Committee, investigation of a whistleblower claim, and audit reviews of Lehman's public filings" (Valukas, 2010, p. 1027). Secondly, according to the examiner's report Lehman's officers engaged in one or more of the following: "(1) *allowing and certifying the filing of financial statements that omitted or misrepresented material information regarding Lehman's use of Repo 105 transactions and their accounting treatment, thus exposing the firm to potential liability; and/or (2) failing to disclose to Lehman Directors information about the firm's Repo 105 program*" (Valukas, 2010, p. 992). Moreover, the examiner found out that there is sufficient evidence that Lehman's officers are not entitled to the business judgment rule presumption regarding Lehman's Repo 105 policy for the following reasons: "(1) *[they] were at least grossly negligent in causing Lehman to file deficient and misleading periodic reports that failed to disclose the firm's use of Repo 105 transactions, thus exposing Lehman to potential liability; or (2) [they] withheld from the Board, which relies upon the accurate transmission of information, material information regarding Lehman's Repo 105 program, thereby depriving the Board of the opportunity to make well-informed decisions about Lehman's leverage and deceiving the Board of Directors regarding Lehman's financial statements. Either one of these factors alone is sufficient to overcome the business judgment rule presumption*" (Valukas, 2010, p. 994).

According to the examiner's report, contrary to the case of Lehman's officers, there is no sufficient evidence to support colorable claims that Lehman's Board of Directors breached their fiduciary duty in regards to Repo 105 policy. "*First, Lehman directors were protected by Lehman's certificate of incorporation from breach of duty of care claims: Courts will uphold such a clause as protecting directors from liability so long as there is not a concurrent violation of the duty of loyalty, which was not implicated here*" (Valukas, 2010, p. 991). Second, with an exception of Richard Fuld, the Board of directors were not informed about Repo 105 policy. This aspect is of great im-

portance considering that EY investigated a “whistleblower” letter sent by Mathew Lee to Lehman’s senior management on May 16, 2008. During the course of investigation, Lee informed EY about Repo 105 practice, specifically about \$50 billion of Repo 105 transactions which were used to move Lehman’s assets off the balance sheet at the end of the second quarter of 2008. The day after this revelation, EY had a meeting with Lehman’s Board of Directors Audit Committee and did not disclose Lee’s allegations regarding Repo 105 policy despite specific instructions from the of the Audit Committee to investigate every allegation made by Lee and to inform the Audit Committee about them.

Finally, in the spring and summer of 2008 Lehman gave multiple presentations to credit rating agencies, in neither of them Repo 105 practice or its effect on Lehman’s net leverage ratio were disclosed. On the contrary, in a presentation to Moody’s Investor Service Lehman argued that “because Lehman had strengthened its capital position through “active deleveraging” including “approximately \$50 billion reduction in net assets,” no negative rating action for the firm was justified” (Valukas, 2010, p. 902). During the examiner’s investigation, none of the interviewed representatives of Moody’s, Standard & Poor’s, and Fitch knew about Repo 105 policy. Furthermore, Fitch’s analyst Eileen Fahey stated “that a transfer of \$40 billion or \$50 billion of securities inventory – regardless of the liquidity of that inventory – from Lehman’s balance sheet at quarter-end would be “material” in Fitch’s view, and upon having a standard Repo 105 transaction described, Fahey remarked that such a transaction “sounded like fraud.” Fahey also remarked that treating a repo transaction as a sale (thereby removing the securities from the transferor’s balance sheet) appears to be an accounting manipulation done to make the business look better, as contrasted with an ordinary repo transaction” (Valukas, 2010, p. 907).

Lehman Brothers were also supervised by government institutions – the Securities and Exchange Commission (SEC) and the Federal Reserve Bank of New York (FRBNY). However, the FRBNY acted mostly as Lehman’s creditor, having two employees at Lehman, whose main task was monitoring Lehman’s ability to repay loans to the Federal Reserve. After Lehman Brothers bankruptcy, in a testimony before the Committee on Financial Services, of the U.S. House of Representatives, the chairman of the Federal Reserve stated that “[b]eyond gathering information, however, these employees had no authority to regulate Lehman’s disclosures, capital, risk management, or other business activities” (Bernanke, 2010).

The SEC was Lehman’s primary regulator, to whom Lehman was required to file quarterly and annual financial reports. In these reports Lehman did not disclose their policies regarding Repo 105 transactions and net leverage ratio calculation despite “[e]ach of these filings required certain disclosures, in each instance subject to the requirement that Lehman provide such “further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading” (Valukas, 2010, p. 967). In her testimony Before the House Financial Services Committee, the Chairman of the SEC affirmed that “the Commission did not perform an audit of Lehman’s balance sheet. Instead, the Commission depended on the integrity of the balance sheet information provided by Lehman’s management which was audited or, in the case of quarterly reports, reviewed, by Lehman’s auditors. Lehman did not disclose in its audited financials that it was undertaking repos as sales – on the contrary, Lehman’s disclosure would lead one to believe that it accounted for all of its repos as financings and that the repos were properly reported as such on the balance sheet. ... It is also clear that the SEC did not do enough as consolidated supervisor to identify certain risks and require additional capital and liquidity commensurate with the risks” (Schapiro, 2010).

Additionally, the bankruptcy examiner stated that during his investigation on-site employees of the FRBNY indicated that in their opinion “the SEC on-site personnel did not have the background or expertise to adequately evaluate the data they were given” (Valukas, 2010, p. 1481) Also, it is worth noting that only in July 2008 the SEC and the FRBNY signed the Memorandum of Understanding, which authorized the exchange of information and analyses about supervised entities between them. Until then the cooperation between the agencies was obscure. Lastly, according to

the Chairman of the Federal Reserve “In September 2008, no government agency had sufficient authority to compel Lehman to operate in a safe and sound manner and in a way that did not pose dangers to the broader financial system” (Bernanke, 2010).

Analysis of Lehman’s bankruptcy showed that without a proper regulation and supervision managers of a public interest entity were capable of hiding material financial information from their Board of Directors, credit rating agencies, government supervisors and the investing public. In this particular scenario, it is also clear that auditors played a vital role since they were the only outside party who had the information about policies in question and chose not to disclose it.

To conclude, analysis of Lehman Brothers bankruptcy showed that in order to have an appropriate (up to date) legal framework and sufficient authority to regulate a sizeable financial institution it is pivotal to adequately identify possible risks and evaluate the complexity of entities and activities supervised. Thus, a coherent cooperation between supervising agencies is needed as well as it is crucial to have a regulatory framework with a plausible threat of penalties or prosecution to those who fail in performing their professional duties.

2. BANKRUPTCIES OF FINANCIAL INSTITUTIONS IN LITHUANIA

The issues related to liability for bankruptcies of financial institutions, their supervision, and prevailing ethical standards in financial sector are especially relevant in Lithuania, because after the global financial crisis of 2008 the third and the fourth then largest banks - Snoras and Ūkio bankas - collapsed as well as many credit unions went bankrupt. Snoras and Ūkio bankas and all credit unions analyzed in this paper had unqualified auditor's opinions when these entities became de facto insolvent.⁵

In the end of 2011, Snoras bank became de facto insolvent when a bankruptcy administrator confirmed that the bank’s assets are worth about €1.2 billion less than it was previously stated. According to appointed bankruptcy administrator *“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”* (Bank Snoras, 2012).

The authorities started liquidation procedures and in August 2012 the Vilnius Regional Court declared Snoras bank bankrupt. The Prosecutor General's Office of Lithuania initiated a criminal lawsuit where the bank’s principal owners were charged with fraud, misappropriation of funds, and other financial crimes.

External auditor of Snoras bank was "Ernst & Young Baltic" (EYB). After the investigation of EYB audits of Snoras bank, the Audit Authority determined that unqualified audit report was released unreasonably. According to the Audit Authority, *“the auditor failed to collect sufficient audit evidence in order to reduce auditing risks to acceptably low level and lacked professional skepticism. Also, EYB allowed additional document being placed in audit report after the report was completed”* (The Authority of Audit and Accounting, 2012). Consequently, the auditor violated Law on Audit of the Republic of Lithuania (Article 27.3.1.) and the International Standards on Auditing (Standard 200 Article 3) and the audit company violated International Quality Control Standard (Articles 45, 46). The disciplinary penalties were imposed both to the audit company and the auditor by the Audit Authority and, after lengthy judicial proceedings, confirmed by The Supreme Administrative

⁵ See more about financial crisis in banking sector in Europe: Miklaszewska, Ewa, and Krzysztof Kil. "The impact of 2007-2009 crisis on the assessment of bank performance: the evidence from CEE-11 countries." *Transformation in Business & Economics* 15 (2016).// Iwanicz-Drozdowska, Małgorzata, Paweł Smaga, and Bartosz Witkowski. "Financial development. have post-communist countries converged?" *Transformation in Business & Economics* 15 (2016).

Court of Lithuania. The auditor's title was cancelled and the company was ordered to improve its auditing controls (The Authority of Audit and Accounting, 2012).

Additionally, in 2014 EYB signed a settlement agreement with Snoras bank and paid LTL 40 million without admitting any wrongdoing regarding disputes related to EYB audits of Snoras bank prior bankruptcy. Finally, after an investigation carried out by the Prosecutor General's Office of the Republic of Lithuania division of Organized Crime and Corruption the auditor became a respondent in an ongoing criminal lawsuit for failing to perform official duties.

In 2013 another sizeable bank - Ūkio bankas - collapsed. After the inspection by the Bank of Lithuania, it was determined that the real value of Ūkio bankas assets was significantly lower than it was declared, with liabilities exceeding the bank's assets by LTL 1.2 billion. In 2014 the bank was declared bankrupt by the Kaunas Regional Court. Also, the principal owner of the bank became a suspect in a criminal lawsuit for alleged misappropriation of the bank's funds.

In this case as well as in the aforementioned cases the bank had unqualified audit report issued by UAB "Deloitte Lietuva" (Deloitte). The Audit Authority conducted its investigation and found out that audits performed by Deloitte were deficient: "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 ISA (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. ... Furthermore, UAB "Deloitte Lietuva" violated the Law on Audit (Article 29.3.) by not complying with International Standard on Quality Control 1 (Article 11b) because of failure to assure that audit reports, which were issued by the audit company or engagement partners were appropriate in given circumstances" (The Authority of Audit and Accounting, 2014a). The Audit Authority imposed disciplinary penalties to the auditor and the audit company (which after the appeals by the auditor were later affirmed by the Supreme Administrative Court of Lithuania (The Authority of Audit and Accounting v. S.B., 2014)) – issued a warning to Deloitte and canceled the title of the auditor.

In 2013 two credit unions Nacionalinė Kredito Unija (NKU) and Švyturio taupomoji kasa became insolvent and got their operating licences revoked. Both credit unions had their statutory audits carried out by the same auditor. The Bank of Lithuania found out that the financial statements of NKU and Švyturio taupomoji kasa did not reflect the exact financial situation of these entities. Thus, both credit unions performed especially risky and undertook various irresponsible and questionable actions, thereby threatening the interests of their depositors. After the inspection of NKU in 2012, the Bank of Lithuania stated: "[i]t was identified that credits were granted without adequately assessing the risk—the reality of the business plans of credited enterprises and the prospects for their implementation were not analyzed; it was not checked whether future debtors had submitted the right data, necessary for the assessment of their risk" (The Bank of Lithuania, 2013a). After the inspection, NKU continued carrying out high-risk activities and the Bank of Lithuania revoked NKU's licence after an appointed temporary administrator concluded that NKU's liabilities amounted to LTL 123.4 million, while its assets were equal to LTL 99.1 million, therefore the credit union was insolvent.

Another credit union – Švyturio taupomoji kasa - faced solvency problems due to a poor quality of loans. The Bank of Lithuania asserted that "[i]nspectors found that in crediting associate members (companies), this credit union did not verify whether the borrower will be able to repay the loan, did not have the information necessary to evaluate the risks of the loans, the information provided by the borrower was not installed on the data validation system. In many cases, decisions on loans were economically unreasonable and non-transparent, while the presented business plans were unrealistic" (The Bank of Lithuania, 2013b).

After the licenses of the credit unions had been revoked, the Authority of Audit and Accounting

(the Audit Authority) started an investigation of statutory audits of NKU and Švyturio taupomoji kasa. The Audit Authority concluded that “auditor A. Sirienė violated the Law on Audit article 27.3.1. by not following International Standards on Auditing regarding evaluation of the effect of applicable laws to the performance of a company, auditors’ liability for fraud, auditing valuation estimates, including fair value accounting estimates and related disclosures, the continuity of activities, the collection and evaluation of audit evidence, the forming of an auditor’s report and presenting an auditor’s opinion. Also, the auditor violated the principle regarding responsibility to the public established in the Law on Audit Article 4.2.5.” (The Authority of Audit and Accounting, 2014b). The Audit Authority indicated the Chamber of Auditors move to cancel the title of auditor A. Sirienė and ordered the audit company UAB “Nepriklausomas auditas” to correct deficiencies found during the inspection. The auditor appealed to the Vilnius Regional Administrative Court, which affirmed the Audit Authority’s decision and concluded that audit deficiencies were reasonably evaluated as significant, therefore disciplinary penalty was appropriate in given circumstances.

In 2014, then the largest credit union in Lithuania – Vilniaus taupomoji kasa (VTK) collapsed. *“Taking into account that the credit union Vilniaus taupomoji kasa fails to comply with all the prudential requirements and its operations and financial situation pose a threat to the interests of depositors, creditors and the public, the Board of the Bank of Lithuania recognized this credit institution as being insolvent and revoked its operating license”* (The Bank of Lithuania, 2014). It was stated that the credit union repeatedly violated capital adequacy requirement and did not apply capital strengthening measures. Additionally, according to the Bank of Lithuania, the executives of the credit union issued high-risk loans and made business decisions in order to fulfill interests of individuals related to the executives, which were *“contrary to the principles of safe and sound credit institution operation”* (The Bank of Lithuania, 2014). The Financial Crime Investigation Service and the Office of the Prosecutor General of Lithuania opened a pre-trial investigation, where 56 individuals were accused of alleged misappropriation of funds, embezzlement, and other financial crimes for fraudulently obtaining loans from VTK and 3 other credit unions including the aforementioned credit unions NKU and Švyturio taupomoji kasa. A total amount of fraudulent loans exceeded LTL 75 million.

The Audit Authority conducted an investigation into statutory audits of VTK and concluded that statutory audits of VTK had significant deficiencies which influenced the release of unreasonably unqualified auditor’s opinion. According to the Audit Authority, auditor D. Stražinskas violated the Law on Audit (Article 27.3.1.) by failing to perform the audit of VTK’s financial statements of 2012 according to International Standards on Auditing. The auditor violated numerous ISAs including, but not limited to the following: failed to obtain sufficient appropriate audit evidence in order to reduce audit risk to an acceptably low level and did not obtain adequate assurance for justifying the auditor’s opinion (ISA 200, Article 5), failed to provide the Audit Authority with the evidence verifying that the auditor properly investigated loans issued to related parties (ISA 550, Articles 11, 25, 28), failed to assess how the management of VTK performs accounting estimates (ISA 540, Articles 8, 13.) and others. The Audit Authority issued a warning to the auditor and ordered him to improve professional qualification by attending 20 hours of audit qualification courses on International Standards on Auditing. Thus, the Audit Authority determined that an audit company UAB “Audata” violated Article 29.3. of the Law on Audit by not complying with International Standard on Quality Control 1 (Articles 32 and 35) and was ordered to correct deficiencies in its quality control system.

Lastly, in September 2016 another credit union – Amber collapsed. A temporary administrator was appointed to the credit union by the Bank of Lithuania. *“This enforcement measure, provided for in the Law on Credit Unions, was applied considering the violations of legal acts and shortcomings in the operations related to cash management, cash operations, etc. identified during the target inspection of the Amber credit union carried out by the Bank of Lithuania The inspection revealed that Amber performed questionable financial operations”* (The Bank of Lithuania, 2016). The Bank of Lithuania revoked the operating license of the credit union after temporary adminis-

trator concluded that its liabilities exceeds its assets, therefore Amber is insolvent. The credit union had unqualified auditor's opinion for the previous financial year.

3. COMPARATIVE ANALYSIS OF LIABILITY CASES

After analyzing numerous cases of collapsed financial institutions in Lithuania during recent years, it is clear that the situation is alarming. Problems related to weak supervision, inefficient regulation, and common unethical behavior in the financial sector can be identified. Contrary to Lehman's case, the demise of financial institutions in Lithuania cannot be attributed to sub-prime mortgages caused financial crisis, real estate market fluctuations or any other external variable.

The case of Lehman Brothers bankruptcy emphasized the importance of auditors' role while auditing public interest entities, considering the fact that auditors had the knowledge about questionable policies implemented by Lehman's management and chose to not disclose them to the Board of Directors and by signing Lehman's financial reports misled government supervisors, credit rating agencies, and the investing public.

Liability of auditors was also a central issue in collapses of financial institutions in Lithuania. In a case where auditor Ana Sirienė appealed to the Audit Authority's decision to impose disciplinary penalty – cancel auditor's title - for audits of credit unions NKU and Švyturio taupomoji kasa, the Vilnius Regional Administrative Court concluded that the auditor had the evidence pointing to mismatched value of collateral for NKU's loans, however she wrote two auditor's opinions – qualified and unqualified. A Qualified opinion (with concerns regarding the value of collateral) was sent to the managers of NKU and after they expressed disagreement with the auditors' views, she filed an unqualified opinion to the Bank of Lithuania. The Court determined that disciplinary penalty was ordered reasonably (A.S. v The Authority of Audit and Accounting, 2015). This and other previously analyzed cases emphasize the importance of having an adequate regulatory framework for auditors' who fail in performing official duties and violate accounting standards or ethics principles. It also offers an insight into the situation where the auditor lacked the incentive to follow the law and chose to succumb to the pressure of audited entity's management, considering that her actions could have *unfavorable* legal consequences i.e. disciplinary penalty or prosecution for failing to fulfill her professional duties and violating the Law on Audit⁶.

Discussing the importance of regulation, supervision, and ethics in financial services sector Lagarde (2016) stated that "*the rule of law plays a key role in creating incentives. A credible threat of prosecution is critical.*" This aspect is particularly relevant in Lithuania considering the fact that until March 2017, i.e. during the time of all the analyzed collapses of banks and credit unions, the Audit Authority had the power to impose only these disciplinary penalties to auditors and audit companies: (1) to issue a warning to the auditor or the audit company; (2) to suspend the validity of the auditors' certificate and to indicate the auditor to retake one or several qualification exams (during a period no longer than three years); (3) In cases, when after the investigation the Audit Authority concludes that audit deficiencies which were discovered qualify as significant, the Audit Authority can indicate the Chamber of Auditors to cancel the title of the auditor and/or cancel the certificate of the audit company. Additionally, the Audit Authority can instruct the auditor to improve his qualification and to command the auditor or the audit company to correct audit deficiencies discovered during the investigation (Law on Audit of the Republic of Lithuania (1999 06 15, No. VIII-1227), Article 38). Considering the importance of performing audits of public interest entities and auditors' role as gatekeepers in financial services sector, it is apparent that these disciplinary penalties did not create strong incentives for auditors to follow the law and high ethics stand-

⁶ See more about auditors' liability and standards: Kiršienė, J., & Misevičiūtė, G. (2016). "Are Auditors at Fault for the Collapse of Financial Institutions in Lithuania?" *Baltic Journal of Law & Politics* 9, no. 2:171-197; Hategan, C. D., et al. (2015). "The relevance of communication through independent auditor's report to the European business environment. comparative study of Romania and Spain." *Transformation in Business & Economics* 14.

ards. First, the Audit Authority's powers were rather limited, since it had no right to impose administrative pecuniary sanctions to auditors or audit companies. Second, the Audit Authority could either issue a warning to the audit company or cancel its certificate. Therefore, the decision of the court in Snoras auditor's case emphasizes the importance of having appropriate regulatory framework with adequate disciplinary penalties available to a supervising authority. In this case, it is evident that the Audit Authority imposed the only disciplinary penalty available to it in these circumstances (after concluding that the audit of a sizeable PIE had significant deficiencies) - cancelling the auditor's title.

The auditor can also be criminally liable for a failure to perform *professional* duties. The only criminal lawsuit against the auditor of a public interest entity in Lithuania is an ongoing litigation against the auditor of Snoras bank. The Lithuanian Penal Code Art. 229 states: "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" (The Lithuanian Penal Code (2000 09 26, No. VIII-1968), Article 229). The prosecutor of the case stated that "the former [Snoras] auditor was charged with a 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 a false illusion of safe investments in Snoras bank, thereby greatly harming the government, the depositors and creditors of the bank" (Prosecutor General's Office of the Republic of Lithuania, 2015).

In January 2017, the first instance court acquitted the auditor stating that "*the auditor did make certain violations, nonetheless these violations do not make the auditor criminally liable. The auditor was already punished adequately when the Chamber of Auditors canceled his title, hence he shall not be punished for the same offense twice*" (Sinkevičius, 2017). It was emphasized that the harm to the public related to Snoras bankruptcy was caused by alleged criminal offenses of Snoras' executives and not by auditor. Also, the judge called prosecutor's arguments (regarding harm to the government institutions, legal and natural persons caused by issuing faulty audit report) "declarative" (Sinkevičius, 2017).

This position of the court and arguments of the judge with regards to harm to the public come as a sharp contrast to a view of the New York Attorney General who filed a lawsuit against Lehman's auditor EY as well as to the opinion of a director of the SEC's Division of Enforcement. In Lehman's case the Attorney General stated that "If auditors issue opinions that are unreliable or provide cover for their clients by helping to hide material information that harms the investing public, our economy, and our country" (Schneiderman (2015). According to the director of Division of Enforcement of the SEC, "*auditors need to exercise appropriate professional skepticism, gather sufficient appropriate audit evidence, adequately document work, and, particularly when there are red flags, require more sufficient evidential matter than representations from management. ... Audit firms are one of the last lines of defense for investors, and they must act accordingly. ... We rely on auditors as essential partners in ensuring comprehensive, accurate, and reliable financial reporting, and they have our full support in this regard. That said, we will continue to scrutinize auditor work in all of our investigations. While good faith errors in judgment will not result in liability, those who fail to follow audit standards and perform unreasonable audits can expect scrutiny through our enforcement efforts*" (Andrew Ceresney, 2016).

It should be also taken into account that globally statutory audit market is dominated by four leading audit companies - Deloitte, Ernst & Young, KPMG, and PwC and it seems highly improbable that, one of those companies would have its certificate cancelled, because prohibiting afore-

mentioned international companies from carrying out their activities in Lithuania would result in capital flight, loss of high-skilled jobs, and likely damage the perception of the country's attractiveness to foreign investors.

The regulatory framework in Lithuania has changed in March 2017, when a new Law on Audit of Financial Statements amending the Law on Audit came into effect. A new supervisory agency responsible for auditors' oversight - The Authority of Audit, Accounting, Property Valuation and Insolvency Management (the Audit Authority) - was established in 2017. Article 56 of the Law on Audit of Financial Statements expands the supervisor's powers by introducing new disciplinary measures in addition to the previously analysed. First, the Audit Authority can instruct an audit company or the audited PIE to terminate their contract on the audit of financial statements upon a determination that the PIE's choice of audit company was restricted according to Article 39 (2) of the Law on Audit of Financial Statements. Second, the Audit Authority can assert that an auditor's opinion does not conform with Article 35 of the Law on Audit of Financial Statements or where applicable Regulation EU (No) 537/2014. (Law on Audit of Financial Statements (Nr. XIII-96, 2016-12-15), Art. 56.3.4.) Furthermore, the Audit Authority can prohibit an employee of an audit company or an executive of a PIE or a board member of a PIE for a period up to three years from serving as an executive in an audit company or a PIE. Finally, the Audit Authority is authorized to impose a fine to an auditor or an audit company of PIE, ranging from EUR 1000 to EUR 100 000 (Law on Audit of Financial Statements (Nr. XIII-96, 2016-12-15), Art. 56.3.5.).

In hindsight, it is evident that this extension of supervisory agency's powers was particularly needed considering distressing situation regarding repetitive bankruptcies of financial institutions in Lithuania while having unqualified auditors' opinions. Also, these changes are in accordance with the EU reform on statutory audit market. European Commission states that *"[a] system of sanctions is key to ensuring that rules are respected and that statutory auditors and audit firms are held accountable, regardless of whether they audit a PIE or not"* (European Commission, 2016). Nonetheless, improvements in applicable regulations alone are not enough. As Lagarde (2016) noted *"[a]ddressing corruption and unethical behavior involves not only improving the quality of the legal framework but also the quality of the individuals who implement this framework."* In the examined cases of insolvencies of the financial institutions in Lithuania, the auditors frequently missed indications of alleged criminal behavior perpetrated by the audited entities' managers, as well as statutory audit supervisors failed to notice indications of many inaccurate audits. As financial services sector becomes more complex the supervising agencies need to have knowledgeable personnel in order to properly evaluate the risks and ensure that statutory audit oversight is sufficient. According to Masciandaro, Pansini, and Quintyn (2011) *"[h]igher skilled professionals with higher compensations are also needed to avoid that the profession falls behind the curve when it comes to new developments in the financial system."*

It is clear that auditors' duties expand beyond formal checking if the financial statements are prepared according to applicable standards. As stated in Lehman's case: *"Technical compliance with specific accounting rules does not automatically lead to fairly presented financial statements. Fair presentation is the touchstone for determining the adequacy of disclosure in financial statements. While adherence to generally accepted accounting principles is a tool to help achieve that end, it is not necessarily a guarantee of fairness"* (Valukas, 2010, p. 965). The strengthened rule of law is essential, yet improved regulation alone could hardly solve particular types of problems faced in this case. *"Whether something is right or wrong cannot be simply reduced to whether or not it is permissible under the law. ... One clear solution is to set a strong tone at the top of the institution - establishing a culture where ethical behavior is rewarded and where lapses in ethical integrity are not tolerated"* (Lagarde, 2015). Therefore, a change in culture of financial institutions is as important as better regulation and supervision⁷.

⁷ See more about the pressures of organizational culture, psychological biases, and lack of financial expertise in: Kiršienė, J. (2014). "The Bank and Credit Union Disasters in Lithuania: Where Were the Lawyers?." *Baltic Journal of Law & Politics* 7, no. 2: 77-94.

While in Lehman's case government institutions (FBI and SEC) after their investigations concluded that there was not enough evidence to bring a case against Lehman's top officials, the distinctive feature in most bankruptcies in Lithuania – principal owners or managers of insolvent entities faced criminal charges for fraud, money laundering, misappropriation of assets, etc. as well as disciplinary penalties were imposed upon the external auditors of the banks and credit unions.

Moreover, the activity in question of different entities' shareholders or managers in Lithuania is rather similar and not indeed very sophisticated in these types of crimes. The bank of Lithuania identified financial institutions examined in this paper issued loans without properly evaluating business risks or solvency of beneficiaries, financed business projects related to key individuals of their management, and immensely overstated the real value of collateral for granted loans. For example, according to the Bank of Lithuania, in 2012 after the problems of Nacionalinė Kredito Unija came to light, additional valuation of collateral for questionable loans was carried out by the State Enterprise Centre of Registers, "which determined that the real value of collateral for 13 suspicious loans is almost 30 times less than it was stated – LTL 2.1. million instead of previously declared LTL 58.1 million" (The Bank of Lithuania, 2013a).

CONCLUSIONS

After analyzing numerous cases of collapsed financial institutions in Lithuania during recent years, it is clear that the situation is alarming. Problems related to weak supervision, inefficient regulation, and common unethical behavior in the financial sector can be identified. Contrary to Lehman's case, the demise of financial institutions in Lithuania cannot be attributed to sub-prime mortgages caused financial crisis, real estate market fluctuations or any other external variable.

Comparative analysis of liability cases after bankruptcies of Lehman Brothers and financial institutions in Lithuania showed that auditors serve a critical role in the proper functioning of financial markets as well as affirmed the importance of auditors' responsibility to the public. It is clear that auditors' duties expand beyond formal checking if the financial statements are prepared according to applicable standards. Auditor is viewed as an independent public accountant - "public watchdog", who is completely transparent. Such auditor's role as well as his responsibility to the public is pivotal to the healthy functioning of financial markets. Also, it is essential for financial entities to establish a culture, in which ethical behavior is endowed while misbehavior condemned.

Analysis of Lehman's bankruptcy also showed that without a proper regulation and supervision, managers of financial institution were capable of hiding material financial information from their Board of Directors, credit rating agencies, government supervisors and the investing public. While in Lehman's case government institutions (FBI and SEC) after their investigations concluded that there was not enough evidence to bring a case against Lehman's top officials, the distinctive feature in most bankruptcies in Lithuania – principal owners or managers of insolvent entities faced criminal charges for fraud, money laundering, misappropriation of assets, etc.

In terms of other safeguards of financial system such as government supervisors and credit rating agencies whose purpose is to inform the investing public about the actual financial situation of financial institutions, the analysis showed that these "gatekeepers" failed, too. For them, it is pivotal to adequately identify possible risks and evaluate the complexity of entities and activities supervised. Thus, a coherent cooperation between supervising agencies is needed as well as it is crucial to have a regulatory framework with a plausible threat of penalties or prosecution to those who fail in performing their professional duties.

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