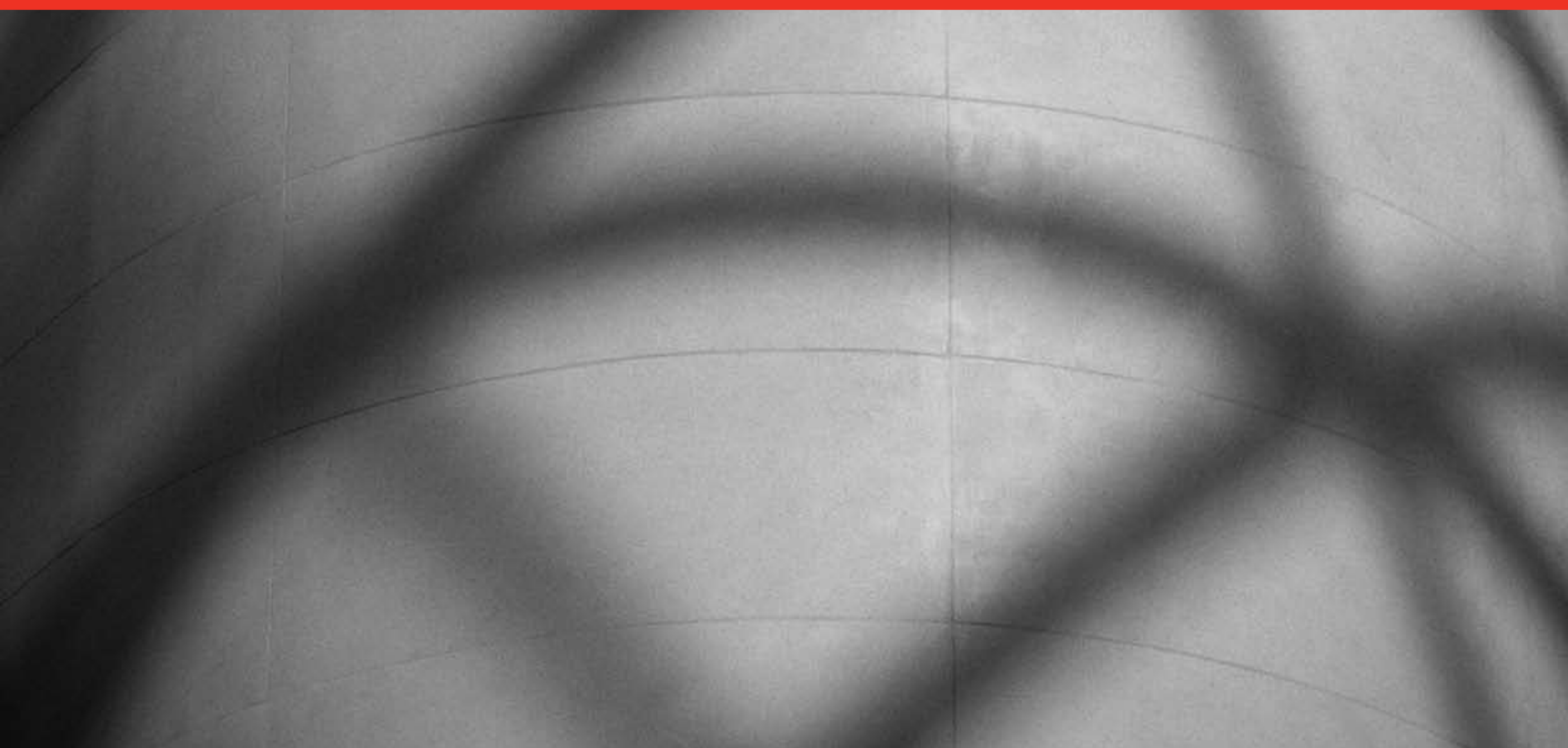
DISCUSSION PAPER

Corporate Governance and the Credit Crunch



ABOUT ACCA

ACCA is the global body for professional accountants. We aim to offer business-relevant, first-choice qualifications to people of application, ability and ambition around the world who seek a rewarding career in accountancy, finance and management. We support our 122,000 members and 325,000 students throughout their careers, providing services through a network of 80 offices and centres. Our global infrastructure means that exams and support are delivered – and reputation and influence developed – at a local level, directly benefiting stakeholders wherever they are based, or plan to move to, in pursuit of new career opportunities. Our focus is on professional values, ethics, and governance, and we deliver value-added services through our global accountancy partnerships, working closely with multinational and small entities to promote global standards and support. We use our expertise and experience to work with governments, donor agencies and professional bodies to develop the global accountancy profession and to advance the public interest. Our reputation is grounded in over 100 years of providing world-class accounting and finance qualifications. We champion opportunity, diversity and integrity, and our long traditions are complemented by modern thinking, backed by a diverse, global membership. By promoting our global standards, and supporting our members wherever they work, we aim to meet the current and future needs of international business.

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This paper was commissioned by the ACCA Corporate Governance and Risk Management Committee, which considers it to be a worthwhile contribution to discussion

The ACCA Corporate Governance and Risk Management Committee exists to contribute to improving knowledge and practice in corporate governance and risk management and to guide and shape ACCA's global strategies and policies in these areas. The Committee, chaired by Professor Andrew Chambers, comprises experts from business, the public sector, academia and ACCA Council.

For more on ACCA's work in this area visit **www.accaglobal.com/governance**

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Arguably the credit crunch is an extreme phenomenon of the business cycle. Whether it is or not, ACCA is keen to consider what the accounting profession can do to enhance understanding of the issue and its implications and to learn lessons for the future. The overall aim of the present paper is to look at the wider picture and to examine how sound corporate governance, risk management and accounting can help.

ACCA has been following developments in the credit crunch closely since mid 2007. It has run events to debate the issues and has contributed to consultations from regulators and standard-setters. This paper sets out ACCA's thoughts on the subject, along with some recommendations. We are very grateful to the experts from the banking, investment and academic communities who have helped us in forming these views.

Executive summary

The credit crunch poses a grave threat to the economies of the developed and developing world. The global banking industry, which was by far the most profitable sector in 2006, is in severe difficulty and the threat that this poses to the real economy is profound. This paper sets out ACCA's thoughts on what has happened and, looking to the future, makes recommendations and considers how accountants can help.

Many of the causal factors seem to be inextricably linked to a failure in corporate governance. Regulatory boxes may have been ticked but fundamental principles of good governance were breached. There should be more emphasis in the performance of corporate governance than with its regulatory compliance. To help improve understanding about governance performance, ACCA is publishing a set of ten corporate governance and risk management principles which we believe have to be observed to achieve good corporate governance. This paper draws on these principles.

Boards should ensure they set the direction of the company and the right moral tone and consider the effects of their decisions on society as well as their shareholders. Yet boards have failed in their responsibilities. Why have boards not asked the right questions? They have allowed inadequate risk management and sanctioned remuneration incentives that influenced behaviour without proper consideration of risk. As a result, companies which should have been run prudently and sustainably, have failed. This is particularly regrettable in view of the social function which retail banking has and the regulatory protection that it therefore enjoys.

Remuneration schemes should promote sustainable business performance. Risk should therefore be taken into account when considering performance-based pay, eg profits from risky activities should attract a lower bonus than would a similar-sized profit from a more secure activity. Failure to address this challenge satisfactorily could frustrate other reforms.

Risk should have been more fully taken into account when making decisions about strategy or operations. Risk management tools have not always been fit for purpose. There has been too much reliance on models which were not properly stress tested and on credit ratings, and insufficient attention given to the big picture. More use should have been made of scenario planning as a risk tool. The risk management function needs to earn, and be accorded, higher status.

Bank boards need to be capable of being held to account, not just to shareholders but to other stakeholders. This is the job of shareholders but, in practice, it is difficult for them to do this for widely held companies.

There is much that needs to be addressed about accounting and reporting. This includes questions about fair value, whether reports need to give a better sense of the range of uncertainty underlying certain material valuations and whether the present accounting model encourages pro-cyclicality.

While some individuals may need to be held to account, it would be wrong to single out a single issue or culprit. The problems cannot be blamed simply on short sellers, government or greed. It would be a serious mistake for regulators to fail to address systemic problems while changing regulations that do nothing more than address the symptoms, in the hope that the problem will go away. We must learn the lessons from what is happening.

This paper is issued as part of ACCA's programme of events, publications and research on addressing the credit crunch.

Introduction

We are now in the second year of the 'credit crunch'. A situation, which manifested itself with relatively minor problems in one sector of the US housing market, has unfolded into a widespread credit and liquidity crisis that threatens a global economic slowdown.

Events have moved rapidly: we know a lot about what has happened, but less about how or why. To the extent that this is a business cycle phenomenon, it is unclear whether it is possible or desirable to prevent such an event recurring. If we want market forces to work we should not be assuming a policy objective of abolishing the business cycle. Bear markets are probably needed to reveal inefficiencies and bad business and regulatory practice. We may need to live with the peaks and troughs that happen every ten years or so, but clearly no one wishes to tolerate the larger cycles that happen every few generations.

The last few years saw unprecedented growth in the size and profitability of the global banking industry. According to McKinsey, global banking profits in 2006 were $788 billion; this was over $150 billion greater than the next most profitable sector: oil, gas and coal. Global banking revenues were 6% of global GDP and its profits per employee were 26 times higher than the average of other industries. Some maintain that such profitability is due in large part to market imperfections arising from the regulatory system, such as lack of competition, information asymmetry, and externalities.

Earlier governments in the US and UK ostensibly put an end to state support of ailing industries. Many may be curious as to why the banking sector, seemingly awash with liquidity in early 2007, now seems to rely on central bank or government support and capital injections from other states' sovereign wealth funds.

This paper complements the ACCA policy paper *Climbing out of the Credit Crunch*. It explores the issues in greater detail and draws on the principles set out in ACCA's *Corporate Governance and Risk Management Agenda* (The Agenda). The Agenda, developed by ACCA's Corporate Governance and Risk Management Committee, sets out ten principles of good governance that are appropriate to almost any organisation, regardless of size, sector or location. The Agenda principles are appended to this paper (page 14), and the full Agenda is available at: www.accaglobal.com/governance.

The root causes of the credit crunch

The overall business cycle has been affected by a number of specific circumstances which increased the cycle's intensity and length. The causes are many, but from a corporate governance perspective, the heart of the problem seems to have been:

- a failure in institutions to appreciate and manage the interconnection between the inherent business risks and remuneration incentives
- remuneration structures/bonuses that encouraged excessive short-termism. This neither supports prudent risk management nor works in the interests of long-term owners
- risk management departments in banks that lacked influence or power
- weaknesses in reporting on risk and financial transactions
- a lack of accountability generally within organisations and between them and their owners.

These factors, combined with information asymmetry between parties to transactions and imperfections in regulation and monetary policy, led to an excess of money supply and, ultimately, to the market dislocation.

Further contributory factors were:

- over-complexity of products and lack of understanding by management of the associated risks
- excessive reliance on leverage in banks' business models
- inter-connectedness of financial institutions
- misalignment between the interests of originators of, and investors in, complex financial products
- failure to appreciate cultural and motivational factors, a rigidity of thinking, a lack of desire to change, an attitude of 'it is not my problem', inappropriate vision/ drivers and, not least, human greed
- lack of training to enable senior management and board members to understand underlying business models and products, leading to poor oversight by senior executives and a lack of rigorous challenge by independent non-executive directors
- complacency after a prolonged bull market.

All these factors played a role; they are complex and interrelated.

Much discussion has centred on possible regulatory reforms. While we accept that changes to regulation may be part of the solution, other changes are needed as part of a more systematic and sustainable solution. Given the breadth of the issues, ACCA's role is to focus on its own area of expertise, particularly governance and disclosure.

The temptation to make scapegoats of individual people or groups should be resisted. While short selling may be, and greed certainly is, part of the problem, there is little to be gained from simply blaming short sellers or 'greedy bankers'. Banning short selling is simply masking the problem. There is a systemic problem and it is vital that we learn the right lessons.

ACCA believes that the credit crunch can therefore be viewed, in large part, as a failure in corporate governance. This should come as no surprise: previous financial episodes such as the savings and loans bank crisis in the US in the late 1980s, the East Asian crisis in the late 1990s and, of course, the failure of Enron and WorldCom, taught us the importance of sound corporate governance and risk management. We did not learn the lessons in the past and must do so now.

The need for good corporate governance

Principle 1 of The Agenda says:

> *Boards, shareholders and stakeholders share a common understanding of the purpose and scope of corporate governance.*

Good corporate governance is about boards directing and controlling the organisations in the interests of long-term owners. It is also about boards being accountable to company owners and accounting properly for their stewardship to ensure sound internal control. Good corporate governance means much more than complying with the letter of regulations and codes. Merely having the requisite proportion of independent non-executive directors on a board and separating the roles of chairman and chief executive is not enough. It means complying with the broader spirit of good governance. Recent events are particularly noteworthy, because they indicate that good governance was lacking at the very financial institutions which both complied with local corporate governance requirements and considered their governance model as best practice.

Principle 10 of The Agenda says:

> *Corporate governance evolves and improves over time.*

It is necessary to look beyond compliance and consider the quality, performance and behavioural aspects of corporate governance. These include remuneration, incentives, risk management and financial reporting to investors and others. Human nature is a common denominator in each of these areas and is influenced by incentives. Accountants must act as gatekeepers and must provide reliable information which can reveal whether incentives are working as intended. ACCA also believes that accountants, as finance professionals for whom ethics is of vital importance, should act as guardians of ethical business behaviour.

Principle 2 of The Agenda says:

> *Boards lead by example. Boards should set the right tone and behave accordingly, paying particular attention to ensuring the continuing ethical health of their organisations.*

It is a question of ethics as well as sound business for boards to ensure that neither their organisation's loans, nor those of intermediaries lower down the chain, are advanced to those with little realistic hope of repaying them. As a society, we rely on bankers to be professional and we must be able to trust them. Bank boards should ensure that, whether they decide to sell or hold a particular transaction, they maintain the same high standards of risk appraisal and disclosure.

We should remember the impact on employees and on wider society. While bank boards owe their primary duty to their shareholders they also have obligations to other stakeholders. The UK Companies Act 2006 clarified the obligations of directors in this respect. It now confers on directors a duty to promote the success of the company and, in the course of making their decisions to that end, they are now required by law to 'have regard' to the following:

i. The likely consequences of any decision in the long term.

ii. The interests of the company's employees.

iii. The need to foster the company's business relationships with suppliers, customers and others.

iv. The impact of the company's operations on the community and the environment.

v. The desirability of the company maintaining a reputation for high standards of business conduct.

vi. The need to act fairly as between members of the company.

While there remains a lack of precision in the practical application of 'regard to' and the scope is limited to UK companies, insufficient regard has been paid by some boards to points i, ii, iv and v. The new requirements under the Companies Act came into effect in October 2007, meaning that compliance with the new statutory requirements could not have been expected before that date. It may be helpful to recall that an argument widely used by those lobbying against the introduction of the new provisions was that they were unnecessary, since all responsible boards took these matters into account anyway.

Principle 3 of The Agenda says:

> *Boards should set clear goals, accountabilities, appropriate structures and committees, delegated authorities and policies. They should provide sufficient resources to enable executive management to achieve the goals of the organisation through effective management of day-to-day operations and monitor management's progress towards the achievement of these goals.*

A fundamental role of the board is to provide direction and control. It was clear that the non-executive directors of Enron and WorldCom did not provide sufficient challenge or oversight of executive management. Reforms, such as the US *Sarbanes–Oxley Act*, those contained in the *EC Corporate Governance Action Plan* and in the *Higgs and Smith* reports in the UK were intended to ensure that non-executives do provide the necessary challenge and oversight. Recent events suggest that this did not happen in some financial institutions. This may be partly owing to a lack of understanding of the complexities of the business but more training is probably not the sole answer. Nor is regulation a substitute for professional judgement or common sense.

Do banks use the best system for promotion? In 2007, the ex-CEO of Citi Group, Chuck Prince, famously said ‘when the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. ‘We’re still dancing’[1]: this may be an appropriate attitude for a trader but it is not suitable for the CEO of a global financial institution.

What else is it that inhibits boards from asking the right questions, from understanding the risks that are being run and from ensuring that these risks are effectively managed?

Accountants have a vital role, using their knowledge, objectivity and professionalism to help ensure that good governance means good performance in the interests of an organisation’s long-term owners. It is not just ticking the boxes.

1. *Financial Times*, ‘Bullish Citigroup is ‘still dancing’ to the beat of the buy-out boom’, 10 July 2007.

Remuneration and incentives

Principle 6 of The Agenda says that:

> *Executive remuneration promotes organisational performance and is transparent. Remuneration arrangements should be aligned with individual performance in such a way as to promote organisational performance.*

Boards need to understand the risks faced by the organisation, satisfy themselves that the level of risk is acceptable and challenge executive management when appropriate.

Performance schemes must be based on sound principles and applied properly. Otherwise there is a risk that a scheme will be used to justify an influential executive's or trader's pay claim. Human nature drives most of us to attempt to maximise our wealth. Existing incentive and career structure packages of banks mean enormous rewards but have contributed to short-term thinking. This lack of long-term thinking neither supports prudent risk management nor works in the interests of other stakeholders in the global financial markets. Arguably this presents a fundamental challenge which could frustrate any other attempts for reform.

It is a human behavioural challenge. Risk management and remuneration and incentive systems must be linked. Profits which involve high risk to an organisation should trigger a smaller bonus than a similar profit which involves less risk. Payments should be avoided or delayed (eg held in an escrow account) until profits have been realised, cash received and 'profits' cannot reverse. On the brighter side, human nature tends to abide by accepted societal ethics; recent events may mean that society will increasingly tend to the view that there is an ethical dimension to performance schemes. This could lead to better-designed performance schemes, where long-term financial and ethical performance is rewarded.

Linking risk management with remuneration incentives would make the risk management function more important in organisations. Risk managers ideally would be regarded as having equal seniority in an organisation to others in the 'front office' and be remunerated accordingly. The risk management function should advise the remuneration committee. We recognise that many risk managers may need to raise their game but an environment where the risk management function is accorded higher status is necessary. This is not about curbing enterprise and innovation but providing transparency to decision-makers and their stakeholders. It is not about box ticking and regulatory bureaucracy. It is about fundamental principles of ethics and professionalism and the clear accountability of those charged with the important responsibility for running our businesses.

It needs the support of boards to make this happen, but boards may need additional encouragement. Fortunately, some institutional investors are talking about these issues to their boards and we encourage them in their efforts. ACCA hopes that shareholders will play a more proactive role in holding boards to account and that this will limit the need for additional regulation.

The basis of charging for financial products and remunerating those selling them means that there will always be an incentive to mis-sell. Asymmetry of information in the selling process means that buyers will often be vulnerable. Boards should ensure that such incentives are properly managed so that mis-selling does not occur.

Principles 8 and 9 of The Agenda say that:

> *Boards account to shareholders and, where appropriate, other stakeholders for their stewardship* [and that] *shareholders and other significant stakeholders hold boards to account.*

It may be questioned whether the relative share of bank income paid as remuneration compared with dividends has been in the best interest of shareholders. Shareholders have limited ability to influence companies they own. Not all shareholders invest for the long term and not all shareholders have an interest in holding boards to account for their stewardship. This has allowed executive managements to extract increasingly larger proportions of corporate earnings. This is a fundamental governance challenge in capital markets where shares are widely held and is not confined to the banking sector. The emergence of new strategies (eg using derivatives) for participating in corporate profitability and new types of shareholder, such as sovereign wealth funds, compound the challenge.

One way to help address both challenges is to ensure that boards and shareholders receive appropriate, clear and reliable information on risk and financial results. Without such information, shareholders stand little chance of holding boards to account. Accountants clearly have a vital role here.

Risk management

Principle 4 of The Agenda says that:

> *Boards ensure their strategy actively considers both risk and reward over time. All organisations face risk: success in achieving their objectives will usually require understanding, accepting, managing and taking risks. Consideration of risk should therefore be a key part of strategy formulation. Risk management should be embedded within organisations so that risk is considered as part of decision making. To avoid creating a risk averse culture, risk should be viewed in terms of both threats and opportunities. Boards need to understand the risks faced by the organisation, satisfy themselves that the level of risk is acceptable and challenge executive management when appropriate.*

Risk management seems to have shaky foundations in some instances. Banks have highly sophisticated risk management functions yet recent events have tested them and found some of them wanting. The report from UBS in April 2008 to its shareholders explaining the reasons for its write-downs provides a clear example of risk management failings.

The UBS report highlights the danger of having silos within organisations. It follows that it is particularly important that risk management itself does not occupy a silo but is integrated with the organisation. Good risk management is the responsibility of the board, management and all the staff; it permeates through an organisation. The risk management function should be to guide, inform and facilitate; it is not 'responsible' for risk.

In early 2007, few bankers investing in mortgage-backed securities (MBSs) or their derivatives thought that they were betting on the viability of their banks. They did not understand the risks and may have believed what they wanted to believe. They were assessing risk with tools which were not entirely appropriate. Boards may not have been giving the necessary time, and may have lacked the expertise, to ask the right questions.

There seems to have been widespread misunderstanding about credit ratings. Some investors may have believed that 'AAA' meant 'safe'. Others were allowed by their employers to buy 'AAA'-rated instruments with little or no further due diligence or consideration of risk. The risks of such activities were not matched to incentive systems.

In addition, as evidenced in the UBS report to its shareholders, employees were able to buy large volumes of MBSs and receive bonuses based on the difference between the yield on the security and the bank's internally charged cost of funds. The pricing of such internal funds is normally subject to less rigorous checking than that applied to external assets or liabilities and does not take account of an organisation's brand value or credit rating. There was very limited downside risk for staff individually, yet the inherent risk to the bank from such a trade, which was enormous, was either ignored or not recognised.

Such activity meant a huge demand for 'AAA'-rated securities. Selling some derivatives of securities has been likened to selling betting slips. Products were created, packaged and marketed which were a 'bet' on the performance of the reference assets. Collateralised debt obligations (CDOs) were created, in part, because there was insufficient volume of underlying MBS origination to meet investor demand – in many cases these CDOs did not have any direct claim on the underlying assets so were reliant for their existence on, and vulnerable to, grades given by ratings agencies.

A low inflation environment stimulated a desire to look for yield in new ways and encouraged derivative trading. Derivative trading, however, is very different from traditional banking. Huge increases in computing power added to complexity by creating the ability to generate many transactions and, thereby, apparently deep markets. The chief executives of banks may not have had sufficient understanding of these new products which, combined with this complexity, meant that traders were allowed to 'get on with it', with CEOs not knowing how to stop or control them. The yields which seemed to be created, aided by AAA ratings, may have mesmerised top management. There was not enough questioning about what 'AAA' meant. Perhaps there is a need to review training programmes, particularly to ensure that rising executives, who may be skilled in a narrow range of disciplines, are fully aware of the risk characteristics of all aspects of the business.

Recent events have highlighted the fact that bank staff had assumed that risks which they thought would net off (eg where A owes B and B owes A) did not actually net off in practice. Risk management procedures should pay more attention to gross risk.

The way we account for risk is a primary driver of capital value. Present prices, showing points, rather than ranges, are not always a good indicator of future asset values. Many of the risk management tools such as value at risk (VaR) assume that 'efficient market theory' works, although it does not do so all the time. Efficient market theory infers the existence of a normal distribution around a mean, it does not take proper account of the risks (particularly credit and operational risks) posed by market variables which do not move in line with normal distributions. Many financial valuations also assume an efficient market. This either needs to be addressed or we have to accept the imperfections and find ways to limit them.

Arguably the root of this problem cannot be addressed in a short period of time – efficient market theory has been the bedrock of economic theory for decades, and changing it is not something that would be possible to achieve. It may be best to point out that the theory, while working in many respects, is not perfect and has shortcomings. Some of these shortcomings have found their way into risk management systems (eg VaR). VaR is too narrow a measure, and improved disclosure could enable these shortcomings to be better highlighted. It would be helpful to disclose a range of values, with an indication of the probability of those values being appropriate.

The UBS report also highlighted a disconnect between incentives and risk management. As set out earlier, risk management should be linked to incentives to restrict payouts on risky activity or delay them until the cash flow has been recorded. This would make the risk management function more important in organisations, although it may be difficult to reform incentives. If one bank pays too soon or too much, others are pressurised to follow suit and, therefore, the sector would need to change as a whole. The aim should be to give risk management priority over pay. Many investors would support this. It should be noted, however, that some financial institutions appear still to be good at risk management, in spite of the credit crunch and also pay well.

In risk management, it is possible to rely overly on the sophistication of maths and forget that a mathematical model is only a model and, at best, an approximisation of the real world. The world and relationships are changing all the time but more sophisticated maths may not tell us more about what needs to be known. Different organisations may use what are essentially similar models and which depend on the same assumptions. If one model ceases to work as intended others may cease to work at the same time. Risk management should rely less on exotic maths risk reporting should rely less on a single number, or point, to represent a range of risk. Risk and financial reporting should say more on the risk and uncertainty attached to numbers in a way in which a financially literate person can appreciate. Scenario analysis could help highlight some of the imperfections of risk management procedures.

Principle 7 of The Agenda says that:

> *The organisation's risk management and control is objectively challenged, independently of line management.*

This is not easy: boards and their audit committees receive a massive amount of information on risk from internal auditors, external auditors, management and other sources. Not all of it, however, is in a useful form. The information is somewhat like pieces of a jigsaw puzzle which need to be pieced together. The jigsaw puzzle is further complicated by pieces being small and having complicated shapes. Unfortunately, the audit committee does not have the picture on the puzzle box, or know how many pieces there are and whether all the pieces it has are part of the same puzzle.

There is a temptation for managers to make sure that information prepared for non-executive directors does not raise too many difficult questions. A partial explanation for boards not understanding their organisations' risks is that information is sanitised by the time it reaches them. Ethics and professionalism are needed when managing information flow.

Internal auditors have an important role here. It is vital that they are both objective and independent. To ensure their independence they must not have any line or management responsibilities but should be clearly separate from the risk management function. The scope of internal audit should include consideration of the risk management function and the board's oversight of risk. It is therefore vital that they are able to operate effectively at a senior level: this requires high competence and sufficient status to obtain respect. Since their activity cannot be inhibited by management, internal auditors should report to the non-executive audit committee chairman rather than to an executive.

We sympathise with an audit committee trying to make sense of all the information and get a complete picture. Fortunately, as with a jigsaw puzzle, we can know the overall shape of what we want to make and we can notice similarities and inconsistencies. Audit committees could find their job easier if they had access to a dedicated function, separate from internal and external audit, which brings together all these sources of information, so that an overall assurance picture is created. Professionalism and ethics figure prominently in ACCA's professional accountancy qualification. Taken together with strong technical financial, accounting and analytical skills, this qualifies ACCA members to help create this assurance picture.

Accounting and reporting

As stated earlier, Principle 8 of the Agenda says that boards should account to shareholders and, where appropriate, other stakeholders for their stewardship. Have the accounts of the banks, which recently posted large write-downs, overstated profits in the past; or are the write-downs and losses a genuine reflection of a changed business environment? At the moment this is unclear. It is also unclear whether it is possible to give early warning of impending losses.

The review by the Financial Reporting Council in 2005 of the UK Turnbull report on internal control concluded that disclosure on risk management information could improve. The revised guidance said:

> *Boards should review whether they can make more of the communication opportunity of the internal control statement in the annual report. Investors consider the board's attitude towards risk management and internal control to be an important factor when making investment decisions about a company. Taken together with the Operating and Financial Review (superseded by the Business Review), the internal control statement provides an opportunity for the board to help shareholders understand the risk and control issues facing the company, and to explain how the company maintains a framework of internal controls to address these issues and how the board has reviewed the effectiveness of that framework.*

The annual report of a major bank is a large document covering several hundred pages and can be difficult to comprehend. At a recent debate held by ACCA, several said that International Financial Reporting Standards (IFRSs) had added to the complexity and length of reports but had not helped clarity or ease of understanding. Both the Financial Reporting Council and the International Accounting Standards Board recently launched projects to tackle these problems of complexity. However, the world is increasingly complex; financial institutions are becoming truly global operations, and reporting on the performance of these global entities inevitably results in complex financial reports.

Accounts do not differentiate between price and value and do not provide a proper snapshot of either value or price. The price of the credit crunch for UBS was calculated in early 2008 as $38 billion of write-downs but these are not actually losses. Anecdotally, it seems that few trades are taking place at these diminished prices, implying that price is different from what many perceive to be value.

Wholesale or investment banks use both accrual and fair value accounting on both sides of the balance sheet. The rules are complex and arguably, at the risk of over-simplification, accounting distortions can occur when markets move and when one side of the balance sheet uses accrual accounting and the other side uses fair value. Financial assets are measured at fair value or amortised cost, depending on the terms of the instrument and depending on the accounting policy election. Similarly, financial liabilities can either be accounted at fair value or amortised cost, although typically proportionally fewer financial liabilities are measured at fair value.

Accounts prepared under IFRSs can produce some seemingly strange results. Many commentators believe it inappropriate that where the 'fair' value of a bank's own debt is reduced, as a result of perceptions about its credit worthiness, the bank is able to report a 'profit' on the reduction. A recent report published by KPMG International, *Focus on Transparency*, observed that 'this has the somewhat counterintuitive effect that if an entity suffers a credit downgrade (or if credit spreads widen) a gain would be recorded in the income statement'. The bank would still be liable for the full amount and the amount would naturally reverse if the debt were not repaid early. The KPMG report noted that twelve European banks recognised such gains in 2007, which for three of these banks represented more than 12% of pre-tax profit. The largest such gain reported was c£1.5 billion. It should, however, also be noted that the accounting policy choice to fair value own debt should be seen in conjunction with another instrument that typically will offset some of the risks. It is the widening of credit spreads that result in counterintuitive profits. Credit spreads can also narrow and would result in losses on own debt.

One view on 'mark to market' accounting is that it is neither good nor bad. But do accountants have a responsibility to warn about its shortcomings? Our view is that they do. The numbers in the balance sheet are 'single point estimates', but many assets and liabilities cannot be accurately represented with a deterministic number where valuation is inherently probabilistic. Current price may be the best estimate of the mean of future values but it may be misleading unless the distribution is normal. A growing body of evidence indicates that normal distributions are the exception in financial asset price distributions.

A downgrade by a rating agency of a CDO by one notch may have the effect that its valuation method goes from 'mark to market' to 'mark to model' (because the market changes or disappears). A downgrade often affects liquidity even in 'normal' times. Liquidity can have a major effect on price that is not reflected in probability of default (PD) or loss given default (LGD), yet many price models ignore liquidity. It is not clear how we should best deal with instruments that become illiquid.

Recent events have highlighted the fragility of financial institutions. Banks, by their very nature, borrow short and lend long and few banks can withstand a sustained run on their deposits. Maintaining trust is a vital component for banks, which will naturally want to maintain a solid appearance. Preparing the accounts on a break-up basis, or with a going concern qualification from the external auditor, would not help and could itself precipitate collapse. However, the fact that auditors have not qualified accounts of banks which have subsequently got into trouble is of concern to users of accounts, who need to know whether an organisation will continue as a going concern.

The credit crunch has posed other challenges for accountants. It may be time to take a more fundamental look at accounting by asking some basic questions.

- What is the purpose of accounts? Is it one of helping to reflect an accurate picture of what has happened, inform about the present, or is it to help predict the future?
- Is a set of accounts expected to do too many things, with the result that reports are unclear?
- What responsibility do accountants have for how accounts are used and what is inferred from them? Is there a parallel with rating agencies, where such agencies may have allowed people to think that a 'AAA' rating meant more than it did?
- What are the expectations of users and are they realistic in the light of events since the start of the credit crunch?
- Should accounts pay more attention to cash?
- If accounts are to reflect risk, should they also reflect the probability or confidence underlying some of the numbers?
- What information does management need to inform and fulfil its stewardship role?
- Should preparers of accounts take more responsibility for clear disclosure? Do we need a broader picture for the balance sheet, profit and loss account and cash flow which convey information on volatility?
- How should information on risks be communicated, including giving better disclosure on complex derivative or securitised products?
- How can the complexity of accounts be reduced and their comprehensibility and value to shareholders be enhanced?
- Is there an expectation gap with regard to audit reports? For example, do people expect an unqualified audit report for a company whose accounts have been prepared on a going concern basis, and without accounting notes that warn of problems, to remain a going concern?

ACCA believes there is a need for more debate and research.

Regulation

While this paper focuses on governance, risk management and accounting it is not sensible to consider the credit crunch without also considering regulation. The banking sector has a social function, it gets its licence to operate from society and is therefore regulated. It is difficult to imagine a modern banking system without regulation and regulation strongly influences bank operations, market forces and profitability. Regulation can also create business opportunity for some and limit competition for others.

Under the Basel Accord, capital requirements change according to the perceived quality of an institution's assets. The business cycle means that a lowering of asset quality tends to occur at the same time as a lowering of capital (because of losses). This means that banks need more capital at the very time that they have less, leading them to reduce assets, worsening the credit environment – the so-called 'pro-cyclicality effect'. It is argued that by 'improving' or sensitising the risk measures, Basel II increased this pro-cyclicality.

Inconsistencies in capital regulations encouraged banks to use off-balance sheet arrangements for holding assets, in order to lower regulatory capital. The credit crunch exposed the fact that off-balance sheet vehicles were still liabilities of the institutions, because of reputational risk or liquidity recourse agreements. We need to explore what is an appropriate balance sheet and capital requirement for banks today. Basel II is essentially a function of assets rather than liabilities and there is probably a need for the capital adequacy regime to consider liabilities as well as assets. Under IFRSs and fair value accounting, price changes feed straight through to reported profits, which in some cases reinforces pro-cyclicality. Given that such values only represent a best guess within a range of possible values, should the present close linkage between accounting numbers and regulatory capital requirements be broken?

Different bank business models may need different regulatory approaches. From a purely commercial view, a bank which relies on short-term funding may be more at risk of having to sell assets at relatively short notice to support the business. A bank relying on long-term liabilities is less likely to need to sell assets to fund operations. It is important to be clear about the time horizon for liabilities.

Retail banks have an important role in society. Their depositors should be protected and so retail banks need some protection too. Arguably, investment banks do not need the same protection but most large banks now have both retail and investment banking activities. Is it desirable or practicable to isolate retail banking activity from investment banking activity and, if so, how? There remains a fear that a bank failure could mean depositors losing their life savings and this fear, in turn, could have a larger effect on society if the depositor base loses faith in the banking system. This leads to the problem of moral hazard: many banks are too big to be allowed to fail and some may be too big for a government to save. They are possibly also too big or too complex for regulators to ensure protection of all depositors.

As we have discussed, the causes of the problems are complex and many. It would be a grave mistake to change any regulation to treat individual symptoms without a proper understanding of the causes. We should be careful, for example, about attributing too much blame to short sellers; we doubt that banning short selling will achieve significant long-term benefits and may well cause other serious problems.

In some regions, particularly in the US and Europe, we seem in danger of having a system that allows profits to be retained in the private sector yet requires losses to be met by the public. This is clearly unacceptable but avoiding this situation poses a challenge. ACCA does not claim to have the answer to this regulatory dilemma but believes a solution will be easier to discern as greater attention is given to the bigger picture and, in particular, to ensuring that organisations are properly governed, risks are better, and more prudently managed, and accounts and related disclosures are clearer for people to understand. There is scope for more research and debate, which ACCA will seek to continue to facilitate.

Conclusion

There are many causes of the current financial turmoil. ACCA believes, however, that a failure in corporate governance is a major contributor to the credit crunch. Regulatory boxes may have been ticked but fundamental principles of good governance were breached. The charitable explanation for this failure is that those responsible did not understand the risks that were being taken. That would suggest a failure of diligence and professionalism. The less charitable explanation is that those responsible knew about the risks but chose to turn a blind eye.

This raises the issue of moral and ethical failure. ACCA believes that this signals a need for a much greater emphasis on professionalism and ethics in business. That is why professionalism and ethics figure so prominently in ACCA's professional accountancy qualification, alongside the need for strong technical financial and accounting skills, and why the demand for people with ACCA international qualifications is growing across the world.

We argue that boards need to provide more effective oversight and to be able to challenge management. We urge shareholders to make greater efforts in holding boards to account. Performance-based remuneration needs to support good long-term and sustainable business performance and should take account of the risk involved. Profits involving high risk should attract a lower bonus payments to staff and management than profits that are less risky.

Risk management will have to improve and be more integrated within the business. The risk management function needs to have equivalent status to the front office and boards should take the same interest in risk as they do in business expansion.

There are many questions which need to be answered about accounting and reporting. Are accounts too complex? Do they convey the right information? What do users need from accounts? What needs to change in valuing assets?

We should have learned more from previous financial crises; it is vital that we learn the lessons now. ACCA will play its part in helping to ensure that we do learn these lessons. As part of a wider programme of activity, ACCA will support relevant research and is calling for proposals in all aspects of the business.

ACCA's corporate governance and risk management principles

These principles, from ACCA's *Corporate Governance and Risk Management Agenda*, are matters which ACCA believes are fundamental to all systems of corporate governance that aspire to being the benchmark of good practice. They are intended to be relevant to all sectors, globally, and to any organisation having a significant degree of separation between ownership and control. Many of these principles are, however, also relevant to organisations where ownership and control lie with the same people.

1. Boards, shareholders and stakeholders share a common understanding of the purpose and scope of corporate governance
There should be a clear understanding of what corporate governance is for. ACCA's view of the purpose is:

- to ensure the board, as representatives of the organisation's owners, protects resources and allocates them to make planned progress towards the organisation's defined purpose.
- to ensure those governing and managing an organisation account appropriately to its stakeholders.
- to ensure shareholders and, where appropriate, stakeholders can and do hold boards to account.

2. Boards lead by example
Boards should set the right tone and behave accordingly, paying particular attention to ensuring the continuing ethical health of their organisations. Directors should regard one of their responsibilities as being guardians of the corporate conscience; non-executive directors should have a particular role in this respect. Boards should ensure they have appropriate procedures for monitoring their organisation's 'ethical health'.

3. Boards appropriately empower executive management and committees
Boards should set clear goals, accountabilities, appropriate structures and committees, delegated authorities and policies. They should provide sufficient resources to enable executive management to achieve the goals of the organisation through effective management of day-to-day operations and monitor management's progress towards the achievement of these goals.

4. Boards ensure their strategy actively considers both risk and reward over time
All organisations face risk: success in achieving their strategic objectives will usually require understanding, accepting, managing and taking risks. Consideration of risk should therefore be a key part of strategy formulation. Risk management should be embedded within organisations so that risk is considered as part of decision making at all levels in the organisation. To avoid creating a risk averse culture, risk should be about both threats and opportunities. Boards need to understand the risks faced by the organisation, satisfy themselves that the level of risk is acceptable and challenge executive management when appropriate.

5. Boards are balanced
Boards should include both outside non-executive and executive members in the governance of organisations. Outside members should challenge the executives but in a supportive way. No single individual should be able to dominate decision making. It follows that the board should work as a team with outside members contributing to strategy rather than simply having a monitoring or policing role. Boards need to comprise members who possess

skills and experience appropriate for the organisation. All board members should endeavour to acquire a level of understanding of financial matters that will enable them to participate in decisions regarding the financial direction and control of the organisation.

6. Executive remuneration promotes organisational performance and is transparent

Remuneration arrangements should be aligned with individual performance in such a way as to promote organisational performance. Inappropriate arrangements, however, can promote perverse incentives which do not properly serve the organisation's shareholders or other principal stakeholders.

Disclosures of director and senior executive pay must be sufficiently transparent to enable shareholders or other principal stakeholders to be assured that arrangements are appropriate.

7. The organisation's risk management and control is objectively challenged, independently of line management

Internal and external audit are potentially important sources of objective assessment and assurance. Internal and external audit should be able to operate independently and objectively, free from management influence. Neither internal nor external auditors should subordinate their judgement on professional matters to that of anyone else. A key part of internal and external audit's scope should be assessment of the control environment including such aspects as culture and ethics.

Internal audit should be able to report directly to the board and should be properly resourced with staff of suitable calibre to work effectively at all levels of the organisation including the board.

8. Boards account to shareholders and, where appropriate, other stakeholders for their stewardship

In acting as good stewards, boards should work for the organisation's success. Boards should also appropriately prioritise and balance the interests of the organisation's different stakeholders. In a shareholder owned company, shareholder interests are paramount but their long term interests will be best served by also considering the wider interests of society, the environment, employees and other stakeholders.

The type of organisation, its ownership structure and the culture within which it operates will determine how boards should account to their owners and/or significant stakeholders. No single model of accountability will be appropriate for all organisations in all regions. A universal requirement, however, is to disclose sufficient, appropriate, clear, balanced, reliable and timely financial, and other, information to those to whom boards should be accountable. Such information should cover the organisation's objectives, performance, prospects, risks, risk management strategy, internal control and governance practices.

9. Shareholders and other significant stakeholders hold boards to account

Owners and, in some cases, other significant stakeholders need to take an interest in the organisation and hold boards to account for its performance, behaviour and financial results. ACCA recognises that, in many societies, the owners of organisations will have to take other stakeholder interests into account. As in Principle 8 above, the mechanisms needed to enable this will depend upon the type of organisation, ownership structure and culture.

Toward this end, a fully independent external audit process, overseen by an effective audit committee, is an important component of good governance. The membership of audit committees should have sufficient financial literacy and at least one member should hold an appropriate accountancy qualification.

10. Corporate governance evolves and improves over time

Organisations in different sectors and across the world operate in diverse environments in terms of culture, regulation, legislation and enforcement. What is appropriate, in terms of governance, for one type of organisation will not be appropriate to all organisations.

A voluntary 'comply or explain' approach to governance, which allows organisations flexibility to innovate and improve as well as enabling stakeholder pressure to enforce good governance practice, is preferable to legislation providing it results in satisfactory standards of corporate governance. Legislation is rigid whereas more flexible systems allow innovation and improvement but at the risk of allowing poor practices to continue, particularly if Principle 9 cannot be upheld.

To assist innovation and improvement in corporate governance and in risk management, there should be flexibility in practices and structures. Corporate governance and risk management will never be fully evolved and may always be improved upon. It is important, therefore, that requirements do not create a straight jacket which prevents innovation and improvement in the ways organisations conduct themselves.

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