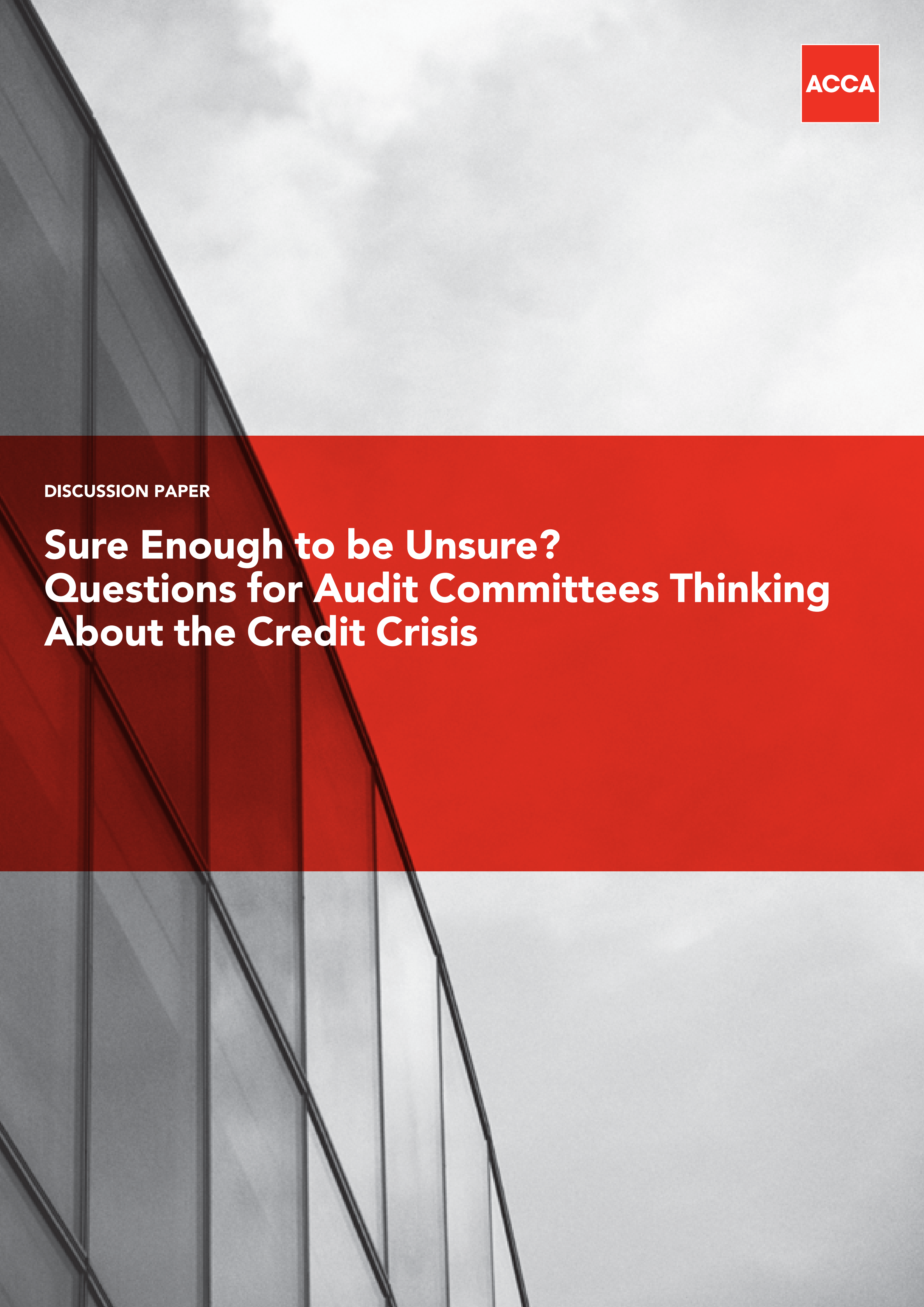

ACCA

DISCUSSION PAPER

# Sure Enough to be Unsure? Questions for Audit Committees Thinking About the Credit Crisis

**ABSTRACT**

Last December, the Financial Reporting Council (FRC) identified that 'corporate reporting and auditing will be particularly challenging this year and needs to be matched by increased diligence and then clarity as to the basis on which judgements have been exercised'. The FRC published a set of key questions to remind audit committees of the key issues. But finding answers may not be easy. This paper considers some of those questions along with the challenges of providing satisfactory answers.

**ACKNOWLEDGEMENTS**

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**

**ABOUT THE AUTHOR**

Paul Moxey is Head of Corporate Governance and Risk Management at ACCA. Paul is a leading contributor to ACCA's responses to global developments in this area, and is an active participant in ACCA's increasing influence on best governance practice.

 Published by Certified Accountants Educational Trust for the Association of Chartered Certified Accountants, 29 Lincoln's Inn Fields, London WC2A 3EE

# SURE ENOUGH TO BE UNSURE? QUESTIONS FOR AUDIT COMMITTEES THINKING ABOUT THE CREDIT CRISIS

**Legend has it that an orchestra on the Titanic played on as the ship sank. Was anyone dancing? Talking about the boom fuelled by cheap credit in July 2007, former chief executive Citigroup, Chuck Prince, 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'.**

He said the party would end at some point but there was so much liquidity it would not be disrupted by the turmoil in the US sub prime mortgage market. He added that 'a disruptive event now needs to be much more disruptive than it used to be.... At some point, the disruptive event will be so significant that instead of liquidity filling in, the liquidity will go the other way. I don't think we're at that point'.

That 'point' came only weeks later. Prince seemingly believed that a liquidity problem was inevitable but did not know when it would happen.

One can understand a highly motivated and incentivised chief executive reasoning that as long as the music is playing you have to dance. But one can also understand the Titanic's orchestra continuing to play; members had no prospect of getting on a life boat and they were playing their part in trying to avoid panic.

An audit committee would not want to be in a similar situation. Faced with a business philosophy of 'dance-if-the-music-is-playing', an audit committee member would be well advised to ask penetrating questions about the chief executive's strategy in the event that the music does stop.

In December 2007, the Financial Reporting Council (FRC) identified that 'corporate reporting and auditing will be particularly challenging this year and needs to be matched by increased diligence and then clarity as to the basis on which judgements have been exercised'. The FRC published a set of key questions to remind audit committees of the key issues. But finding answers may not be easy. Here are some of those questions along with the challenges of providing satisfactory answers.

*Are the risk management procedures adequate to identify and evaluate all relevant risks and exposures across the group on a timely basis?*

Who would the audit committee ask? Could any one person within the organisation give assurance on 'all relevant risks and exposures'? In most organisations the reality is that there is an assurance gap when it comes to getting a complete picture of all significant risks a business faces and how they are being mitigated.

Typically the audit committee receives reports, a risk register and answers to questions from management, external auditors and internal auditors. This is like having a jigsaw puzzle, but with no idea of how many pieces it contains, no picture of the completed puzzle, or even whether the pieces are part of the same puzzle.

What is needed is an assurance function which attempts to paint a picture of the puzzle, puts the pieces in place and identifies any gaps. It is unfair to expect part-time audit committees without an intimate knowledge of the business to solve the puzzle.

*Does the group finance function have sufficient skill, experience and resources to prepare the annual report in the current circumstances?*

This is not necessarily just a matter of skill and experience. Material assets and liabilities may be valued using models where fine adjustments to the model, or the assumptions behind it, could have a considerable impact on the value. Our financial reporting and auditing models lack the subtlety to communicate properly that the numbers are not always as certain as they appear.

*Is the audit committee adequately briefed on key issues (relating to year-end planning)?*

How can an audit committee know if it was not adequately briefed? Until recently liquidity risk was not regarded as a key issue, so a bank audit committee could think it had been reasonably briefed – without hearing a word about liquidity risk. Audit committees should know if there have been any significant changes in either accounting policies or methods for valuation.

*Is there any evidence that current developments have any implications for information reported in prior periods?*

If there is such evidence, what should audit committees do? It is worth remembering that in 2006 and 2007 10% of companies listed in the US and having clean 404 opinions under Sarbanes-Oxley subsequently had to restate their accounts to correct a material error.

*How will the board satisfy itself that it is appropriate for the financial statements to be prepared on a going concern basis? How realistic are the assumptions underlying the cash flow forecast?*

Many boards would rely on their internally derived management accounts-based cash flow forecast, the robustness of which will be judged by the external auditors. It is hard to imagine a board choosing to prepare accounts on a basis other than 'going concern' without auditors first insisting on it – the consequences would be severe. Audit committees would now do well to take the initiative in considering whether the company will remain a going concern.

*Does the business review present the risks, particularly the financial risks, associated with the group's activities in a fair way?*

Reporting on these risks is a relatively new requirement and companies have understandably been reluctant to disclose anything other than the fairly obvious and common knowledge on risk.

*Has due care and diligence been applied in valuing financial and other assets reported at fair value?*

The audit committee should satisfy itself that due care and diligence have been applied and ask how sensitive are the valuations to various assumptions and how reasonable are those assumptions.

*Have appropriate disclosures in relation to financial instruments been made in accordance with relevant accounting standards?*

How aware should the audit committee be of such specialised disclosure requirements? There are additional reporting requirements for years starting after or on 1 January 2007, such as a sensitivity analysis for each type of market risk. It may be sensible to rely on external auditors to advise that all relevant accounting and auditing standards have been met but audit committees should also consider if, overall, the report and accounts give a balanced, fair, comprehensible and accurate view.

*Have the auditors provided any ad hoc services or advice which could compromise their independence and objectivity in light of current market circumstances?*

The audit committee may also want to know whether the auditor has changed their approach to accessing the valuation of complex instruments and the rationale for any change. Might an instrument have attracted little critical attention in the past but now be subject to intense scrutiny by an auditor who is naturally reluctant to sign off on a transaction now regarded as high risk?

*Has management prepared a thorough assessment of exposures and risks and what procedures are in place to mitigate those risks?*

Can management be sure enough to be unsure? Banks have highly sophisticated risk management systems, yet some seem to have been caught by surprise. Certain types of risk, such as liquidity, were until recently either not considered or felt to be too remote a risk to worry about.

*What is the group's loan default experience in recent months and how does this compare with experience prior to the credit market turbulence? Are the procedures and methodologies in place to assess allowances for impairment appropriate? Are resulting impairment allowances appropriate?*

Risk assessments are often back tested over a few years but not always far enough back to the last time when liquidity was tight, or where there were other extreme market conditions (generally every 10 years or so).

*Has management adequately identified and re-assessed the risk profile of securitisation structures and products?*

If management can say yes to this question, can it be sure enough to be unsure?

*Have appropriate disclosures been made in accordance with relevant accounting standards?*

The audit committee should be satisfied it understands the assumptions behind various disclosures and the sensitivity of disclosures to what may seem minor changes in assumptions.

*What further explanations, in addition to those required by standards, may be needed in the annual report to provide transparency in relation to off-balance sheet arrangements?*

Many companies will choose not to disclose more than necessary. The audit committee should keep in mind the question: does the annual report provide a fair and balanced view?

*Is there sufficient substantiation of the assumptions underlying any valuation techniques applied and models use and what is revealed by any sensitivity analyses that have been performed?*

To what extent should an audit committee understand the models used and how they work? It should know whether the models are generic and widely used in industry or if they were they created by the particular derivative staff involved in the transactions being valued. It should also know to what extent external auditors relied on representations made by the model designer and ask if a counterparty to a transaction would attribute the same value.

Once again it may not be easy for an audit committee to arrive at an informed opinion on this. In some cases few people, other than the creator of a model, will understand how valuation models work. This is an area which few internal auditors look into. Even if an audit committee is reassured about the assumptions underlying a model it will also need to be assured the model has been properly stress tested. Anecdotal evidence would suggest that recent stress testing did, in some high profile cases, not include liquidity risk.

Some people say there is a moral dimension to the current credit crisis, they say it was wrong for sophisticated organisations to be party to practices which led customers, with relatively little financial knowledge, to borrow more than they could afford in order to buy property the value of which had already been over inflated by the availability of cheap credit. ACCA believes boards should set the right tone and pay particular attention to ensuring the continuing ethical health of their organisations. Directors, and especially non-executive directors, should regard one of their responsibilities as being guardians of the corporate conscience.

It is clear that audit committees will have their work cut out. Their job has always been challenging but it has become even more so. People may question if too much is now being asked of audit committees. Meanwhile, audit committees might ask themselves and their advisors – are they sure enough to be unsure?

## ABOUT ACCA

ACCA (the Association of Chartered Certified Accountants) 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.

**TECH-TP-SEU**

**ACCA** 29 Lincoln's Inn Fields London WC2A 3EE United Kingdom / tel: +44 (0)20 7059 5000 / www.accaglobal.com