

# The Audit Committee and the Credit Crunch

Paper prepared for the Audit Committee Chair Forum

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The Audit Committee Chair Forum (ACCF) is convened by the CBI and Ernst & Young and is facilitated by Cranfield University.

The Forum comprises a select group of audit committee chairs from the UK's leading companies. Our aim is twofold, namely:

- to influence the direction of regulation as it impacts audit committees, and
- to act as a vehicle to develop points of view and best practice.

The Forum provides an opportunity to contribute to the debate, influence its direction and improve the performance of audit committees.

The Forum is currently chaired by John Buchanan, Audit Committee Chairman of AstraZeneca, with Gerald Russell, Senior Partner at Ernst & Young, and Martin Broughton, President of the CBI.

This is the eighth paper produced by the ACCF. Previous papers include:

- The role and function of the Audit Committee
- The drivers of audit quality
- What is an effective audit and how can you tell?
- Audit Committee regulation: 'Financial literacy' – what does it mean?
- Audit Committee communication: What is said, why, how and to whom?
- The role of the Audit Committee in risk management
- The role of the Audit Committee regarding non-audited information

*To obtain copies or learn more about the ACCF please contact the Forum Secretary, Sarah Woodthorpe at the CBI, [sarah.woodthorpe@cbi.org.uk](mailto:sarah.woodthorpe@cbi.org.uk)*



## Executive summary

- **No one response to the economic situation**

The impact of the credit crunch will vary dependent on whether or not the company is in the financial services sector, and on its current financial position.

- **External auditors are paying more attention to forecasts and going concern**

In many companies, audit procedures are the same as in previous years, but there is somewhat more focus on budgets and forecasts, and on the financing position of the business and its banking covenants.

- **The Board and the audit committee are examining treasury and financial policies, as well as the financial statements**

Many of the issues discussed in this report are being dealt with at Board level as well as, or instead of, by the audit committee.

Some of the audit committees already incorporated regular covenant reviews and treasury reviews into their agenda, and so had processes for dealing with this. Others had formally added these items to their workload.

- **Funding is critical**

Audit committees are examining closely the company's ability to roll over loans when they come to the end of their term.

Treasury policies are being inspected in detail in the light of the current economic climate.

Bank covenants are being monitored closely, and more stringent stress-testing is being done than previously.

- **Business activities**

Audit committees are aware of the need to monitor the financial status of major trading partners. For some, this was already part of their agenda.

Attention is being paid to the likely impact on revenues, profits and cash flows of an economic slowdown.

- **Financial statements**

Accounting policies such as mark-to-market are causing difficulties in many companies, resulting in volatile accounting results.

Accounting for pensions is leading to problems in valuing both pension assets and liabilities.

The Boards of many companies are not clear whether their pension funds are holding sub-prime debt. This is a matter for the audit committee to investigate.

Changes to accounting standards on pension funds are unwelcome at this particular point in the economic cycle.

- **Communicating with investors**

Although the market needs information, there is a nervousness that it might over-react to news.

Narrative disclosures and investor presentations should be examined carefully by the whole Board before release.



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## Introduction

The economic turmoil caused by the sub-prime crisis has led to a credit crunch in the developed world economies. Banks are more reluctant to lend, and are imposing more restrictions on the loans they do make. This is causing problems for companies whose banking facilities are facing renewal. It is also one cause of an economic slowdown which may lead to recession, impacting companies' future trading.

This paper reflects the discussions of a meeting of the Audit Committee Chair Forum (ACCF) held on 7th April 2008 to address the ways in which audit committees are responding to the credit crunch and related issues. Additionally it draws upon published sources, upon telephone interviews with seven members of the ACCF (five of whom attended the meeting) and upon interviews and discussions previously conducted with members of the ACCF.

The interviews and meeting directly related to this matter solicited the views of eleven chairs of the audit committees of leading companies, four audit partners from Ernst & Young, and two CBI representatives.

The formal questions addressed in the briefing document circulated prior to the ACCF meeting are set out in Appendix 1.

## Impact of the credit crunch on the audit committee

The first thing to note is that the impact of the credit crunch and economic slowdown will vary dependent on whether or not the company is in the financial services sector, and its current financial situation and borrowing requirements. For companies outside the financial services sector and having strong balance sheets with no short-term need to renegotiate funds, it is less of an issue than for many other organisations.

The impact of the current economic situation was seen in a variety of ways:

1. in changes to audit committee processes and the external audit
2. on company funding
3. on business activities
4. on the financial statements
5. on investors.

It is worth noting that although the ACCF reflects the views of chairs of audit committees, discussion in the meeting and telephone interviews highlighted that this area is a matter for the whole Board rather than just this sub-committee. Many of the issues discussed below were considered to be Board matters, even if the detail of some of them was initially dealt with at audit committee level.

## Changes to audit committee processes and the external audit

*“[We’re] really getting behind the numbers and saying: What would we have to drop down to before there was a problem? And the investors were interested in that too.”*

Some of the ACCF members reported that there had been little change in the processes surrounding their external audit, taking the view that procedures for examining debt covenants, supply chain issues, etc had always been in place and were adequate. These issues always form part of the audit agenda, and interviewees reported that the meetings between the auditors and the audit committee had not reflected much change from normal procedures.

However, in other companies there was a greater focus by the external auditors on financing issues and the trading potential of the business.

In discussion of the work of the auditors, reference was also made to the various checklists percolating through the system to assist in evaluating the business and the financial statements in these turbulent economic times. (For examples, refer to Appendix 2) Some of the audit firms had particularly drawn the audit committees’ attention to these checklists.

A key concern in relation to the attitude of external auditors was the choice and implementation of accounting policies in terms of the marking-to-market of financial instruments, and as regards the impairment of intangible assets. Both of these matters are discussed later in this report. In particular as regards the auditors, the view was that there is no incentive for them (or for others, such as rating agencies) to take an optimistic view of business prospects. Thus, this could lead to stringent write-downs, more than might perhaps be required.

As regards internal processes, the main change was that considerably more attention was being paid to financing headroom, to the ability to meet banking covenants, and to future cash flows. It was agreed that these matters are relevant to the audit committee, but not just to the audit committee, and that it was important for the Board to be fully au fait with the full situation, as these are live business issues.

*“If you have not been [having regular updates on treasury, tax and pensions] it would need a lot to get up to speed.”*



## Impact on company funding

*“I, as an NED, am interested to hear whether our [treasury] policies are deemed to be robust as to the current climate, and if not... what nuts and bolts are we choosing to tighten?”*

The aspect of the credit crunch of most concern to all of those participating in this work was its impact on company funding. For most of the companies discussed, medium-term funding arrangements were in place, so there was no immediate cause for concern. However, the change in the credit climate was focusing attention on what may happen over the next few months and years, and consideration was being given as to when and how new funding would be renegotiated, and on what terms.

There was a clear emphasis in many companies on stress-testing banking covenants, and taking a more stringent view on this than had previously been the case. The level of headroom on facilities was seen as another key point for review. In this respect it was felt useful to have experienced independent directors on a Board – individuals who had been in business through a deep recession, and could envisage just how difficult trading could get.

Treasury policies too were attracting more attention, with the audit committee and Board focusing on the exact terms of these policies, such as how much funding could be placed with each institution, and what policies were to be adopted for hedging. For some companies this was just a continuation of an ongoing schedule of reviews, although particular focus was being paid to ensuring the credit-worthiness of deposit-taking institutions. The policies were being reviewed to ensure that they were still appropriate, and that they were drafted so as to lead to action if needed.

*“Specialists [CFO and Treasury] present the policy to the audit committee. The audit committee presents it back to the main Board. But the audit committee has the first bite at it.”*

## Impact on business activities

*“Aged debtors has taken a little more attention than in previous years.”*

In addition to the impact of the credit crunch on a company’s financing, its wider effects can be seen in the economy in general, and in a company’s supply chain. Even if the company itself has no immediate problems, credit issues or the economic slowdown could affect its suppliers and customers. Accordingly, many of the audit committees were examining their companies’ reliance on key partners in the supply chain, and considering how such reliance could be mitigated if needed. However, no-one participating in these discussions believed that any of their supply chain partners was in jeopardy.

Many of the ACCF members pointed out that a review of potential over-reliance on a particular supplier or customer is just part of the normal risk review practices, and so was being done anyway.

One audit committee chair highlighted an incident during a previous recession, in which a company whose business was conducted through joint ventures was unexpectedly called upon to back these joint ventures financially, even though this requirement was not apparent in the terms of the agreement.

In all cases, downside scenarios were being prepared to determine the possible effects on the business and the financials, in the short- and medium-term, of a prolonged recession. Here, the important issue was not particularly the failure of customers, and the resulting bad debts, but rather the revenue, profit and cash flow impacts of a slowdown in the economy.

## Impact on the financial statements

*“If there’s not a market, it’s difficult to mark to it.”*

Discussion of the impact of the credit crunch on the financial statements fell into two main categories. One was the impact on the financial statements in general, which related mostly to mark-to-market issues and impairment of intangibles. Secondly, the ACCF members considered the impact on the company’s pension fund and how this affected the financial statements. These are dealt with separately below.

### Financial statements in general

*“If we’re heading for a slowdown or recession, the current accounting rules ... are going to put a lot of stress in the system.”*

*“It’s difficult to get an assessment of how consistent people are being. It’s not that there are different approaches to valuing exactly the same thing; it’s that there aren’t any ‘exactly the same things’.”*

The major area of discussion on the financial statements was the impact of accounting policies such as mark-to-market on investments and financial instruments. This issue was discussed extensively, with the key problem being that mark-to-market is difficult when there is not a realistic market against which to value the instruments. In current times, prices are volatile or artificially depressed by forced sales, and this was believed to result in misleading values and write-downs in the financial statements. These were on occasion proving difficult to explain to stakeholders.

The discussion at the ACCF meeting included consideration of ideas recently promulgated by some commentators regarding marking to average market prices instead of those at the year end date. However, no consensus views were reached.

It was noted that all of the Big Four auditing firms are taking approximately the same line on mark-to-market, and so companies’ results could be said to be consistent, even if they were not very informative.

A second area of concern was in relation to the valuation of goodwill and other intangibles, and the need for impairment provisions due to the economic climate. As stated earlier, the audit committee chairs considered that auditors were likely to take the lowest common denominator and mark everything down. The general feeling voiced by the meeting was that values were spiralling down, in that everything was being treated as worst case.

It was further noted that financial statements will also be difficult to understand at some future time when the economy improves, and many of these adjustments are reversed: “The more pain we take now, the greater the upside in the recovery.”

Overall, mark-to-market and provisions were seen as a contentious area, and the thrust of the views expressed was that GAAP<sup>1</sup> results no longer represent a realistic position for companies. (This point was made in connection with the post-IFRS<sup>2</sup> environment in general, although it is exaggerated by the effects of the credit crunch.)

In particular, the income statement has become less relevant, as balance sheet ‘fair value’ adjustments are put through. A concern relating to this was whether current practice by banks and

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<sup>1</sup> Generally Accepted Accounting Principles    <sup>2</sup> International Financial Reporting Standards

investors, looking at the non-GAAP ‘underlying’ profit (without the distortions of mark-to-market and other adjustments) would continue to be favoured in analysis. It was suggested that these parties might begin to take a more cautious view of the financial statements, focusing more on the GAAP profit rather than the underlying, and that this would present more financing and presentational problems for companies. This was summarised by one member, discussing the attitude of lenders, as “Could we be moving from an era of covenant-lite to covenant-heavy?”

## Pensions provisions

*“In a company that has not got any exotics on its balance sheet, is relatively prudent, not ridiculously over geared, has a fair spread of businesses ... it’s most likely that the thing to come and hit you will be the pension fund.”*

Three aspects of pension funds were discussed in relation to their inclusion in the company’s financial statements: the value of liabilities, the value of assets, and the potential changes to accounting standards.

As regards the values of assets and liabilities, it was noted that in some ways the economic situation has made things better for pension funds. As interest rates have risen, the rate used to discount future liabilities has increased, and so those liabilities are shown at a reduced amount, which flatters profits. However, for the majority of companies this benefit is wiped out by the losses on equities that have been recorded. Mark-to-market valuations have also proved difficult, as discussed above.

A related issue arises in determining exactly what assets the pension fund holds. In recent years there has been a trend towards encouraging pension funds to hold higher-yielding assets: exactly the type of loans that, given artificially high credit ratings, led to the credit crisis. A concern was expressed by many of those in the ACCF discussion that their Boards were not clear about what ‘assets’ were held by their pension funds. Noting that a lot of the estimated sub-prime debt has not been identified, further concern was expressed as to whether the pension fund trustees themselves were sure of what they held. It was agreed that this was an important area for the audit committee to address.

*“In answer to the question ‘are you in the sub-prime game?’, for many of our Boards it’s difficult to know the answer.”*

The final pension-related issue, which was a significant concern to the ACCF members at the meeting, was the potential changes to accounting standards that would lead to re-statements of pension liabilities due to changes to the discount rate used. The audit committee chairs were neither for nor against the changes per se, but strongly voiced the opinion that now was not a good time to be tinkering with accounting standards on pensions.



## Impact on investors

*“We thought [the interim management statement] was going to be a flea-bite: it’s going to be more than that.”*

It is notable that investors’ attitudes to corporate funding have changed significantly over the last year. Before the credit crunch, activist investors were demanding that companies take on considerable amounts of debt, mirroring the capital structures of some of the more aggressive private equity investments. Several of the audit committee chairs pointed out that if this had been done, those companies would now be facing significant financial difficulties. Indeed, so fundamental has been the change in sentiment that levels of gearing that were previously considered acceptable, even low, are now being treated warily by the investment community.

Related to this change in investor perceptions was the expressed need for companies to be careful about the ways in which they communicated with the markets. This was particularly relevant in relation to the business review and other non-financial disclosures in the financial statements, and in releases such as the interim management statement (IMS).

For the business review and for the IMS the general view was one of caution, with the view being expressed that the tone of these narrative documents was key, and that the independent directors, and in particular the audit committee, should have input into what was said, and how.

In some companies, where the financial situation was robust, this had been stated clearly in the narrative reports. However, other boards had taken the view that to do so at the current time was a hostage to fortune, and their statements reflected ‘business as usual’ rather than specifically highlighting financing. Overall it is fair to say that the narratives were more cautious in tone than had been the case a year ago.

Many companies which had completed the narrative reports in their financial statements had chosen not to highlight separately the risks surrounding the future availability of finance. The view was that this was dealt with implicitly in the disclosures, and to emphasise it would give it undue prominence and cause an issue in perception that they did not believe was there at that point in time. Boards were concerned that investors would over-react at the slightest hint of an adverse statement.

## Questions to Ask Yourself?

1. As an audit committee, how are we ensuring that the Board is fully au fait with the impact of the credit crunch on the business and the financial statements?
2. What judgement issues in the financial statements are likely to be particularly affected by the credit crunch, and how will these be tackled?
3. Do we understand the current financial position of the company's pension fund(s), and what is being done to preserve this, and to reflect it in the financial statements?
4. What should we be telling the investors and other stakeholders about the impact on our business of the current economic situation?



## Appendix 1

### **Questions included in the briefing document circulated prior to the ACCF meeting**

1. What has your audit committee done to ensure that they understand the business, funding and accounting impacts of the credit crunch?
2. How, if at all, have considerations of the credit crunch affected the content or level of the audit committee's interaction with the external auditors in the current reporting round?
3. With regard to the impact of the credit crunch, what is your audit committee likely to do differently for the next round of reporting (be it full year financial statements, or interims)?

## Appendix 2

# Some published sources of guidance on audit committees and the credit crunch

### Guidance published by the Financial Reporting Council (FRC)

<http://www.frc.org.uk/press/pub1467.html>

On 17th December 2007 the FRC highlighted the reporting issues facing companies in the light of current economic conditions. Their guidance Key Questions for Audit Committees considers financing issues, risk management, accounting and narrative reporting. The accompanying press release includes the following explanation.

*“The FRC has responsibility for the Combined Code on Corporate Governance and its associated guidance on internal control (the Turnbull Guidance) and audit committees (the Smith Guidance). While the FRC believes that this guidance continues to be appropriate, it felt that members of audit committees might find it helpful to have a reminder of some of the key issues to be considered in preparing corporate reports in the coming months.*

*The FRC has, therefore, prepared some additional questions for audit committees to consider. A first group sets out questions which are likely to be relevant to audit committees of all companies. A second group of questions is likely to be relevant to audit committees of financial institutions or other companies which make use of complex financial products. These sets of questions are not exhaustive but are intended to stimulate consideration and discussion of the relevant issues. These questions are attached as an Appendix.”*

### Resources published by the Institute of Chartered Accountants in England and Wales

#### Credit Crunch Issues

<http://www.icaew.com/index.cfm?route=153360>

On this website the ICAEW brings together a series of resources on: accounting matters relating to financial services companies in the current illiquid markets; going concern issues facing companies in all sectors; and specific guidance directed at auditors.





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