EUROPEAN
AUDIT COMMITTEE LEADERSHIP NETWORK
ViewPoints

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Consequences of the credit crunch

Introduction

On 27–28 March 2008, the European Audit Committee Leadership Network met in Milan for its ninth meeting. Members discussed the consequences of the credit crunch in two parts. First, Professor Stefano Preda, Chairman and CEO of Banca Esperia and former President of Borsa Italiana (1997–2000), joined the network for a discussion of the macroeconomic impact of the credit crisis. Members then discussed the impact of the credit crunch on their own boards and audit committees. Separately, members also discussed increasing audit committee effectiveness.[1]

For further information about the network, see *About this document* on page 8.

Members identified the following consequences of the credit crunch:

- **Actions for audit committees**
- **Considerations for corporate boards**
- **Challenges for regulators and standard setters**

The members of the network participating in the meeting sit on the boards of over 40 large-, mid-, and small-capitalisation public companies. Network members participating in the meeting included:

- Mr John Buchanan, Audit Committee Chair, AstraZeneca
- Mr Per-Olof Eriksson, Audit Committee Chair, Volvo
- Prof Guido Ferrarini, Audit Committee Member, Atlantia
- Mr Wim Kok, Audit Committee Chair, ING
- Mr Daniel Lebègue, Audit Committee Chair, SCOR
- Mr Pierre Rodocanachi, Audit Committee Member, Vivendi
- Ms Guylaine Saucier, Audit Committee Chair, Areva
- Dr Klaus Schlede, Audit Committee Chair, Lufthansa and Deutsche Telekom
- Mr Kees Storm, Audit Committee Chair, Unilever and InBev
- Dr Bernd Voss, Audit Committee Chair, ABB

Members from Ernst & Young participating in the meeting were:

- Mr Tom McGrath, Managing Partner, NEMIA Client Service and Accounts
- Mr Christian Mouillon, Managing Partner, CWE Client Service and Accounts

ViewPoints reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made before and during meetings are not attributed to individuals or companies. However, Prof Preda has given permission for his remarks to be attributed.

[1] European Audit Committee Leadership Network, *Increasing audit committee effectiveness*, *ViewPoints*, 21 April 2008. Available at: http://www.tapestrynetworks.com/documents/Tapestry_EY_Euro_ACLN_Apr08_View15.pdf.

Executive summary

Members gathered in Milan to discuss the wide range of impacts of the credit crunch on businesses in Europe and to share insights into its impact on the boards and audit committees of both financial and non-financial businesses. During a series of discussions, members focused on:

- **Actions for audit committees** *(page 2)*

  Members agreed that while the full effects of the credit crunch are still unfolding, audit committees would do well to take certain actions to ensure the company's financial health, including reviewing the investment policy and treasury function, reviewing pension fund investments, assessing the enterprise risk management system and addressing disclosure requirements. Audit committees should also be aware of the increased risk of sub-prime-related litigation.

- **Considerations for corporate boards** *(page 5)*

  In light of the credit crunch, executive remuneration and the impact of the economy on business performance are top considerations for corporate boards. Members asked whether executive bonuses in financial institutions contributed to a *"culture of greed"* that encouraged risky investments. In considering the impact of the economy on their companies, members discussed the risk of inflation and the effect of a declining dollar. One unexpected advantage of the current economic situation for public companies has been its handicapping of private equity competitors.

- **Challenges for regulators and standard setters** *(page 6)*

  Members see the credit crunch as the result of actions in the US and welcome the fact that the US' Federal Reserve Bank and Department of the Treasury are working on reforms to address its root causes. Members noted that in Europe, although Basel II could not have prevented the crisis, it could have lessened its impact had it been fully implemented before the crisis hit. Members also discussed the need for standard setters to tackle the accounting-related causes of the crisis.

Actions for audit committees

A 2006 Ernst & Young global survey of audit committees revealed that of the five risks boards felt were most significant, market dynamics came last.[2] The consequences and duration of the current credit crisis are as much of a surprise to members of audit committees as they are to other market participants. The impact of the crisis on audit committees has varied widely and depended primarily on which industry they are in, with those in financial services facing greater immediate and longer-term challenges. National differences are being seen as well, with countries such as Italy and Spain – which did not deal in securitised sub-prime mortgages – faring better than countries such as the UK.

Commenting on the deep effect the credit crunch has had on audit committees, one member said: *"The agenda of our audit committee has changed … since the [credit] crisis. I have, in every meeting, three main issues: the company's risk management, liquidity, and the valuation of assets".* Network members agreed on several important steps audit committees should take in the wake of the credit crunch. Their recommendations are outlined on pages 3-5.

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[2] Ernst & Young, *Audit Committee Perspectives: 2006 Audit Committee Survey and Industry Insights,* page 1, 2007. Available at: www.ey.com/global/download.nsf/Luxembourg_E/Audit_Committee_Perspectives_06/$file/EY_Audit_Committee_Perspectives%202006.pdf.

Review investments, investment policy and the treasury function

After the onset of the sub-prime crisis, audit committees took a hard look at potential exposures through company investments. Prof Preda commented: *"The crisis has spread to markets you didn't expect ... even AAA-rated securities are not liquid"*. A particular issue is the current risk associated with commercial paper and money market funds. External auditors are advising audit committees to ask for assurance from financial staff and internal and external auditors that all exposures have been identified and quantified. Some companies will be forced to take a loss, and others may have to wait for funds to reopen before they can access their investments, both of which will affect the treasury function and represent financial risk. One member asked: *"What if you were in the position of needing [your commercial paper], and you couldn't access it? Then you could really have a problem"*.

Determining the fair value of financial assets and liabilities is a key focus. Audit firms have issued guidance on how existing International Financial Reporting Standards (IFRS) and US Generally Accepted Accounting Principles apply in that process. For example, International Accounting Standard (IAS) 39.9 provides guidance for determining value in active and inactive markets.[3]

The next step, for several network members, has been to review the company's investment policy, with the goal of aligning investments to it. Members report that the treasurer often has a great deal of autonomy in making investment decisions, possibly with limited guidance from management and the board. One network member said: *"The practical answer is to invite the treasury department to give a presentation to the audit committee on risks, renewals, lines committed, loan maturity, and relationships with the banks"*. Thinking of the recent Bear Stearns crisis, members also raised concerns about counterparty risk. One stated: *"[Audit committees need to focus on] customer- and supplier-based counterparty risk, issues around holding bad products, refinancing, and [the likelihood of] more adverse audit opinions"*.

External auditors advise companies to be sure their investment policy is up-to-date and broad enough to ensure the treasury is not assuming too much risk. Audit committee members should be asking what their companies are invested in and the risk premiums associated with those investments. Members reflected upon the future of financial securitisation products, speculating that one consequence of the credit crunch will be a continued lack of trust in complex financial instruments. One stated: *"No one asked questions about why [companies were] suddenly making money in one area. Are we ensuring that we are measuring risk against where we suddenly make money? We need to ask this question on a regular basis. Tomorrow there will be another sexy product after sub-prime [securitisation]"*.

Review company pension fund investments

Members reported looking at pension funds regularly – in many cases, annually. The credit crisis has provided impetus for a more immediate review. *"Let's look at this now, not when it comes up on the agenda"*, said one audit chair. Pension funds face challenges similar to those that financial institutions face in the valuation of assets. A member reported on the complexity: *"Pensions are different [to other investments]. There has been an equity drop. It's a question of risk appetite. Risk appetite is hugely different across different countries and [from] where it was before the crisis"*.

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[3] Global Public Policy Committee, *Determining Fair Value of Financial Instruments under IFRS in Current Market Conditions*, 2007. Available at: http://www.ey.com/Global/assets.nsf/International/Media_GPPC_Paper_IFRS/$file/GPPC_Paper_IFRS.pdf.

Assess enterprise risk management systems

Enterprise risk management has been high on the agenda for audit committee chairs in recent years, and the current crisis has driven home the need for an effective system for identifying, quantifying and managing risk. One member, speaking before the meeting, reported that last September the audit committee had, by chance, undertaken a review of the treasury operation and requested a series of 'what-if' scenarios that proved useful during the crisis. The member said: *"For example, [we asked] what is our funding profile if a problem like a downturn in profits or a reputational issue mean[s] not being able to borrow? … It provoked a view in me that management wouldn't be able to see the impact of a bank crisis, and they are only waking up to it now".*

Financial institutions are actively reviewing enterprise risk management systems. Bank boards are under pressure to ensure that rigorous risk management systems are in place and being utilised. Several cases have emerged that highlight the reluctance management may have regarding reporting problems: management at German bank IKB, for example, may not have informed the board of its sub-prime exposure.[4] Meanwhile, in Italy, a major review of banks' corporate governance is under way.

One member said management has *"the responsibility to bring [audit committee members] the risks that face the corporation. Yet the issue is that top management doesn't understand these [financial] products either".* Another said: *"When you use a complicated financial instrument, you start to think, did I know everything? It makes you think twice".* It is still unclear whether the risk systems were at fault or whether the credit crunch was more a consequence of a deliberate choice to accept greater risks in order to drive greater returns.

Members debated the role of the audit committee with respect to risk. One member stated: *"We can't pretend that we can look into the future and say we can be responsible for all kinds of risk. We couldn't have seen the sub-prime risk. We need a [risk] system, but we must also be modest".* Another countered: *"But isn't that our role? To be sure all the major risks are identified? We can't oversee it all, but [we can] help to identify [risks] and be sure they are overseen".* Members agree there is work to be done in this area, including being clear about roles and ensuring management and the board are fulfilling those roles.[5]

Address increased disclosure requirements

The credit crunch puts new emphasis on IFRS 7 (Financial Instruments: Disclosures), which requires detailed information on the various financial risks arising from financial instruments (including those that are off-balance-sheet) and how the risks are being managed.[6] Audit firms also stress that once companies have identified how various financial instruments expose them to risk and are able to accurately value those instruments, disclosure is a must – even if the disclosure will negatively impact the company's stock. In the US, the Securities and Exchange Commission has already sent letters to

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[4] Wietske Blees, *IKB Concealed Sub-prime Risk From the Board, Auditor Says, Risk,* 17 October 2007. Available at: http://www.risk.net/public/showPage.html?page=477994.

[5] For further discussion of the role of the audit committee with regard to risk management, see the European Audit Committee Leadership Network's *Increasing audit committee effectiveness.*

[6] A technical summary can be found at: http://www.iasb.org/NR/rdonlyres/8177F9A2-EB2F-45A3-BBF3-3DE7DCB13E1A/0/IFRS7.pdf.

public companies – which it has identified as having investments in structured investment vehicles and collateralised debt obligations – requiring specific disclosures.[7]

Members discussed concerns about disclosure regarding valuation in the absence of a market. One member said: *"You should disclose what you do with mark to model, your assumptions, etc".* Another added that you have to disclose *"mark to market that day, but things move, and you can comment on that".* Another member recommended: *"You might disclose the percentage of values which are [mark] to model or to market".*

Be aware of the increased risk of sub-prime-related litigation

Lawyers are reporting that the number of suits filed against organisations involved in the sub-prime crisis has risen dramatically, and they expect the trend to continue. Banks and investment banks may face lawsuits from a wide array of litigants.[8] Jamie Wareham, Global Chair of Litigation at leading international law firm Paul Hastings, recently told the North American Audit Committee Leadership Network that, "the sub-prime meltdown could represent trillion-dollar losses, with potential knock-on effects such as transaction failures and 'substantive plaintiffs' firms going after non-financial companies'. He added: 'Anything funded by off-balance-sheet [vehicles] will be under question'".[9] Audit committees will need to assess the need to reserve for and disclose these new litigation risks.

Considerations for corporate boards

Network members identified and discussed two important considerations for corporate boards in the wake of the credit crisis:

- Remuneration policies and 'tone at the top'
- The impact of the economy on business performance

Remuneration policies and 'tone at the top'

For US investors, the credit crunch has given new impetus to 'say on pay' proposals (proposals to grant shareholders advisory votes on executive remuneration). Activist investors are suggesting that executive bonuses encouraged management to make riskier investments because of the allure of possible returns. Members discussed the nature of financial services and the challenges of *"a wealth creation culture"* or, as another put it, a *"greed culture".*

One member reported that the board is taking action to address this concern: *"Greed will find a way around any controls you put in place. We decided to take a good look at our compensation policy at all levels of the company. [We are asking ourselves], are we motivating a greed culture that will put us all at risk again?"* Other members suggested that audit committees will have to work more closely with remuneration committees in the future.

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[7] Tammy Whitehouse, *SEC Gives Help on Sub-prime Disclosures, Compliance Week,* 2 January 2008. Available to subscribers at: http://www.complianceweek.com/index.cfm?fuseaction=article.SavedSearchResults&search_ID=121.

[8] Perkins Coie, *Sub-prime Lending Troubles Spawn Widespread Litigation*, 2007. Available at: http://www.perkinscoie.com/news/pubs_detail.aspx?op=updates&publication=1372.

[9] See Audit Committee Leadership Network in North America, *Litigation Risk and the Audit Committee, ViewPoints,* 14 March 2008. Available at: http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Mar08_View19.pdf.

The impact of the economy on business performance

Prof Preda highlighted members' concern that the full impact of the crisis has yet to be felt: *"Italy is exposed to the consequences of the credit crisis, but I think the experience is very new. We are at a point that is very strange".*

While member companies outside financial services are not currently reporting a significant impact from the credit crunch, they say tensions will remain high for the next few years as the world waits for the full impact to be felt. Members believe there are further write-downs to come from regulated financial institutions, with one member noting: *"For private equity and hedge funds, there are no disclosures. They might still have a hit to report. This creates uncertainty".*

Members predict that the liquidity crisis will continue and will impact their own companies' ability to refinance debt or borrow for investment at competitive rates. One member said: *"Most of the big institutions have not felt the effect yet. Over the next 12–18 months, there will be a rude awakening when [companies] can't get money to invest in new projects".* Another agreed: *"Access to liquidity and capital markets financing will be an issue for all, and for a long time".*

The likelihood that inflation will be the next phase of the crisis was also raised during the meeting. A member said: *"We aren't looking [out for] inflation, and it is coming. It's a problem of the dollar sliding too much".* Members also report concerns over falling sales in the US and speculate that this trend will continue until the dollar regains its value. One member predicted: *"The US will be very competitive with a low dollar. Europe will become a museum. I believe Asia will rise next".*

One unexpected benefit of the present crisis for public companies has been the inability of private equity firms to use cheap credit to compete for strategic acquisitions, or even to bid for large public companies themselves. One member said: *"For [cash-rich companies], the crisis is good. We have a lot of cash. We are buying things in dollars, too. Buying companies. Our stock price is down … but we are no longer a target for venture funds as they can't get the money to buy us".* Prof Preda agreed: *"Private equity has different issues than other markets. They have less opportunity [now]".*

Challenges for regulators and standard setters

Understandably, members are very interested in what is being done to address the underlying causes of the credit crunch and ensure the longer-term health of the global economy. Discussions included a review of the international regulatory response (including the impact of Basel II) and the impact of the crisis on accounting standard setters.

Support for Federal Reserve policy

Members generally agree that the actions of the US Federal Reserve (Fed) to date are appropriate, given the nature of the current crisis. One member said: *"The Fed is very active and acting with intelligence".* Another reflected: *"If Bear Stearns had gone down, what counterparty risks would [the other investment banks] have faced?"* That said, members also say increased financial regulation is a necessary quid pro quo of Fed intervention: *"If you accept that the Fed will intervene, you need rules".*

Some network members suggested that regulation of the sort that some European nations have in place could have prevented some of the events that occurred in the US and the UK. One member said:

"Even Northern Rock couldn't have happened in [my country] because our regulation is stricter on matching assets and liabilities". Another member added: *"What the Fed is doing is taking the role that governments would take in Europe. The US hides nationalisation through intervention of the Fed behind JPMorgan Chase".*

Regulatory reform

Just after the network meeting in March, the US Treasury released its *Blueprint for a Modernized Financial Regulatory Structure,*[10] the product of more than a year's effort, undertaken at the urging of US Treasury Secretary Henry Paulson. The blueprint offers short, intermediate and long-term recommendations for improving the US regulatory structure, including clarifying how the Fed should handle liquidity issues following its emergency bailout of Bear Stearns.[11]

The blueprint also calls for the creation of a new federal commission for regulating the mortgage origination process, a step that network members say is crucial: *"The US [institutions] are 100% responsible for the sub-prime [crisis] … We need to take serious measures to prevent another disaster. We need regulation and supervision. How [could] a non-bank grant credit without regulation?".*

Additionally, members call for a greater degree of international coordination between authorities and countries: *"It's a pity to observe ... this lack of economic policy coordination. The US and Europe are diverging more and more, [with] the dollar [caught] in the middle".* One member asserted: *"Europe needs to be reform-minded to improve competitiveness and not be complacent".* This member then asked: *"What happens when the US tool kit is empty and the worst is yet to come?".*

The implementation of Basel II – the internationally recognised standard for banks that is seen by most commentators as a significant improvement on Basel I – was already under way when the credit crunch began to take hold. Critics of Basel I say that it encouraged financial institutions to move credit risk off their balance sheets, leading to a lack of clarity around their asset portfolio contingencies. One member stated that if Basel II had been in place *"it wouldn't have prevented the situation, but it would have made it less of a problem".* Others criticised Basel II for focussing on the wrong issue – capital requirements for banks – when it was illiquidity in the markets that became the central issue in the summer of 2007.

Challenges for accounting standard setters

At the meeting, members reflected upon the fact that this is the first *"post-IFRS global financial crisis".* One member said that the IFRS were being pressure-tested by the crisis. Some members voiced dissatisfaction with the standards, calling them *"too academic"* and saying: *"We need traditional [historic value] accounting".*

Market commentators have also been critical of IAS 39 (Financial Instruments: Recognition and Measurement), believing the accounting rules are a root cause of the crisis by authorising the de-recognition of assets. One member described the standard setters' response as having a boomerang

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[10] US Department of the Treasury, *Blueprint for a Modernized Financial Regulatory Structure*, 31 March 2008. Available at: http://www.treas.gov/offices/domestic-finance/regulatory-blueprint/.

[11] Ibid, pages 83–85.

effect from too lax to overly stringent as a result of the crisis. This arises primarily because marking to market forces issuers to book short-term losses that may not be their final losses.

Similarly, in the US, Financial Accounting Standard No. 140 (Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities) has been seen as flawed, and one ongoing long-term project of the Financial Accounting Standards Board is to review it and eliminate the concept of qualified special-purpose entities.[12]

Conclusion

Audit committee chairs in Europe are facing up to the consequences of the credit crunch for their companies and the European economy. Although there is plenty of blame to apportion (much of it focused on economic institutions on the other side of the Atlantic), European board directors are also aware of the potential shortcomings of their own countries' regulatory regimes and the need to redouble their efforts to improve risk management systems in their own companies. Large European public companies have not been immune to the complexity of securitisation products or to attempts at fraud. The suggested actions for audit committees outlined in this document provide a helpful checklist that can be utilised by any audit committee that wants to ensure that the operations and investments of a company are sound, whether the company is in the financial services business or not.

About this document

The European Audit Committee Leadership Network is a select group of audit committee chairs from leading European companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit committee environment.

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management and their advisers as they endeavour to fulfil their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *ViewPoints* may share it with those in their own network. The more board members, management and advisers who become systematically engaged in this dialogue, the more value will be created for all.

[12] Tammy Whitehouse, *SEC Gives Help on Sub-prime Disclosures.*