

Global credit crunch: the role of the auditors



The global credit crunch has proved traumatic for the international financial system as many institutions have reported huge write downs in asset values and some have been pushed into forced sale to prevent bankruptcy.

Since the US sub-prime problems began to bite in August 2007, one major US institution – Lehman Brothers – has gone bankrupt, and other key mortgage providers in both the USA (Fannie Mae and Freddie Mac) and UK (Northern Rock and Bradford and Bingley) have become dependent upon central government support for their survival. In addition, a number of other institutions have survived only through an arranged take-over.

It has been suggested that the global financial economy has never in recent years been tested by quite such a combination of accidents and jolts to confidence. In relation to accounting practice, some commentators have argued that the credit crunch crisis has been exacerbated by the use of fair value accounting. These concerns have continued to grow in prominence in the financial press, leading to stock exchange regulators and politicians around the world calling for its suspension, accompanied by vociferous counter-arguments from those supporting fair value accounting and challenging what they see as undue political interference.

In contrast to earlier corporate crises, such as Enron, WorldCom, or Barings, the role of auditors in the credit crunch appears to have received relatively limited media coverage. More evident focal points have been the banking institutions themselves, the strength of their business models, associated remuneration structures and incentive based cultures and the problems being generated by the rise of increasingly complex financial instruments. Press comment on auditors has been largely confined to instances where audit reports have been modified, or valuations challenged.

The credit crunch and bank crises

The credit crunch began in summer 2007, when accumulating losses on US sub-prime mortgages triggered widespread disruption to the global financial system. The problems originated in the growing practice by banks and other mortgage providers of using special purpose entities or collateralized mortgage obligations (CMOs) to "slice and dice" their credit risk exposures. For non housing loans, collateralized debt obligations (CDOs) provided similar opportunities for institutions to pass on their risks via the sale of special bond issues.

A key factor in the crunch is illiquidity in the market for sub-prime mortgage based CMOs due to increasing uncertainty about the value of the underlying collateral. The value of a bond purchased from a CDO or CMO is usually model based, and dependent upon a set of assumptions about the risk of the underlying collateral, but such assumptions are both subjective and uncertain. Most importantly, the perceived risk at the time of purchase of such bonds may change over time, leading to a change in their value.

The lower the assumed risk, the higher the value of the bond and vice versa, and so issuers may be tempted to overprice bonds whilst investors lack the full information required to make an independent judgement of the risk. Market liquidity is thus dependent upon buyers being confident that prices reasonably reflect the risk-return trade-off, and the credit crunch originated (and still continues) because this confidence evaporated. Buyers rightly began to suspect that their bonds would collapse in value as the sub-prime

mortgage default rates increased. As a result of the falling prices, many institutions incurred large losses on complex structured securities, resulting in an increased demand for liquid assets. Unfortunately, as the lack of confidence further reduced liquidity in many of the credit markets, the problems only worsened. Consequently, financial institutions have experienced periods where they have suffered major falls in the value of assets combined with vanishing market liquidity.

By April 2008, the five largest UK banks – HSBC, Royal Bank of Scotland, Lloyds TSB, Barclays and HBOS – had recorded write downs and asset impairments totalling approximately £22 billion. The level of exposure to the crunch varies between institutions, however, and it is accepted that both HSBC and Lloyds TSB have limited their activities in the CDO and sub prime markets. Nonetheless, HSBC reported that its profits fell by 28 per cent in the first six months of 2008, as it recorded over US \$10 billion of impairments on US mortgages and a further US \$3.9 billion of write-downs on credit crunch related securities within its trading operations. HBOS, the UK bank most exposed to the crunch, saw profits fall by more than two thirds over the same period, and loan write offs and trading debt write downs amounted to £2.4 billion.

Following further falls in its share price, HBOS agreed to a £12 billion take-over by Lloyds TSB, a deal that had to be renegotiated in early October 2008 as market prices continued to fall. In the UK, such falls subsequently also triggered the nationalization of the Royal Bank of Scotland and the launching of a £37 billion governmental rescue package for UK's biggest banks – which followed on from a \$700 billion bail-out plan in the US, notable not just for its sheer scale but the battle engaged by the US President and Treasury Secretary to secure the approval of Congress.

Auditors and the credit crunch

A key problem for auditors is the verification of the valuation of illiquid assets, bearing in mind the consequential impact that such valuations can have on the reported profits (or losses) of major banking institutions. The auditor's role is to attest that the published financial statements give a "true and fair" view of the reporting entity's financial position and performance but in volatile markets, significant adjustments to opinions on valuation may be required within a very short time frame, and for companies highly exposed to collateralized debt markets, valuing these elements of their balance sheets is not straightforward.

When preparers and auditors have access to liquid markets that serve as a reference point for a valuation, reaching agreement on security values may be relatively simple, but when market liquidity dissolves, problems begin to surface. As credit markets have seized up, it has become very hard to obtain genuine "trading prices" and alternative methods of reaching a valuation have been adopted. Many of the mortgage linked securities on the books of the largest banks are valued at quasi market prices, which are based not upon the price of the security itself, but an extrapolated value taken from associated derivatives' indices such as ABX, even though these indices are open to criticism because they are relatively new and also highly volatile.

In semi-liquid markets, another possibility is for auditors to use so-called "distress" prices, or the prices realized in a fire sale as the reference point, but the definition is open to interpretation. The IASB's Expert Panel has recently recommended a narrow definition in order to avoid a problem reported privately by auditors – that clients have attempted to widen the definition in order to record higher prices than the last traded fire-sale price. In the absence of even quasi market prices, so-called level three assets and liabilities are valued using mark-to-model, in which mathematical models based upon a set of assumptions about future events predict forecast cash flows as a basis for security valuation.

The resulting values may, however, be highly sensitive to changes in the underlying assumptions. Recent calculations by the Bank of England, for example, show that if tiny changes are made to the type of model typically used by banks to value mortgage-linked debt, the implied price of supposedly "safe" assets can suddenly change by as much as

35 per cent. The use of model-based valuations also raises two other potential problems for auditors. The first is the need to audit the internal controls used by the client in arriving at its model based valuations. The second relates to the expertise of the audit team, with the PCAOB Chairman, Mark Olsen, expressing concern that auditors "may not have the extensive training in valuation techniques necessary to verify companies made the right choices." Under such circumstances, the audit partner needs to not only recognize the need to use experts, but also decide on how to make use of their inputs in the audit.

Where were the auditors?

The current credit crunch is one that is increasingly witnessing the drawing of parallels or comparisons with past financial crises, most notably whether it is on a scale that may ultimately match that of the 1929 Wall Street Crash. However, the recent banking collapses and the massive downgrading of bank share prices have not generated the frequently asked, high profile question from the media as to "where were the auditors?"

Analysis of the headline media coverage of the credit crunch is suggestive of various explanations for the apparent lack of attention to the bank audit function. In some cases, events triggering corporate collapses have been portrayed as mid-year trading events and, implicitly, presumed not to have any connections with previously reported, and audited, financial data. Accordingly, if trading positions had got out of control since the publication of the last year's accounts, this was not an audit problem.

There are also indications that the post-Enron, Sarbanes-Oxley arena is such that stakeholders are now expecting more of management and not seeking to use auditors as scapegoats for management failings. If corporate lending had become excessively risky and speculative, this was a consequence of poor management strategy and direction. If executive remuneration and incentive structures had been wrongly aligned, or if rogue traders had been allowed to run amok within a bank, this was a management control error not an audit failing.

It is also possible, however, to argue that the audit profession has been very active in this crisis. The market has responded to signals contained in annual audit reports, reports to regulators and expressions of concern emanating from auditor-auditee discussions over valuation issues and the underlying strength of banking business. Institutionally, there have also been a series of public interventions by the auditing profession. National and international auditing standard setters have issued practice recommendations and revised standards. The big audit firms collectively have published documents reminding auditors of key issues to consider when conducting audits of financial institutions in troubled times. Presentations have been made to, and dialogue pursued, with key regulatory and public oversight bodies. The profession has been spreading a message that it has a role to play.

Taken collectively, opposing interpretations of the role of audit in the credit crunch reflect that the situation is a more complex one than first impressions would suggest but one that is also demanding of serious attention. Constructive, challenging and important debating issues are clearly plentiful – but they need addressing – and addressing in a mature and open fashion, that is respectful of, and sensitive to, both practical auditing experience and alternative understandings, constructions and theorizations of practice. If this does not happen, and the financial crisis continues to deepen, one question will come to dominate – namely "where were the auditors?" – and who can say whether that will be followed by an even more poignant one for the auditing profession, namely: Do you remember something that we used to call external auditing?

April 2009.

This is a shortened version of "Crunch time for bank audits? Questions of practice and the scope for dialogue", which originally appeared in *Managerial Auditing Journal*, Volume, 24 Number 2, 2009.

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