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Global Financial Crisis- accounting and audit considerations

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Agenda

- Some questions / statements on the crisis
- Origin of the Crisis
- Current State
- Complex financial instruments
- Impact on the Global Economy
- Changes in Standards / Guidance
- Dealing with the crisis
- Accounting and Audit Considerations

Some statements and Questions?

Statements from M. Nicolas Sarkozy, President of France:

– Laissez-faire is finished!

Capitalism is over!

Era of Self Regulation is over!

The period of American Domination is over!

Current State

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Origin of the Crisis

First shoe to drop was the collapse in June 07 of two hedge funds owned by Bear Stearns, that had invested heavily in sub-prime market.

As the year went on, more banks found that securities they thought were safe, were tainted with what came to be called as “ toxic mortgages”.

Rising number of foreclosures escalated fall in housing prices, and the number of mortgage defaults began to increase..

In March 08, Fed staved off Bear Stearns bankruptcy by assuming $ 30 billion in liabilities and engineering a sale to JP Morgan Chase.

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Current State

Extraordinary events over the last 10 weeks

Sept 7, 08

- Fannie Mae & Freddie Mac rescued by US Govt. , placing these companies under government control. The plan also replaced management’s of these entities. This plan committed $ 100 billion to each entities.

Week ending Sept. 16, 08

- Lehman files for bankruptcy
- Merrill Lynch agreed to be sold to Bank of America for roughly $ 50 billion to avert deepening crisis.
- Insurance Giant AIG teetered under the weight of losses, taken over by US Government by injection $ 85 billion bail out.

Current State
Extraordinary events over the last few weeks

Sept. 16, 08

- Terrible Plunge : After bankruptcy of Lehman Brothers and sale of Merrill Lynch, Dow Jones fell by 504 points, worst loss since 2001.
- Shares of AIG fell to $ 4.7 (less than 10% compared to share price of $ 72 a year ago)

Week ending Sept. 20
- With many credit markets not functioning normally, investors world wide frantically moved their money to safest investments.
- Dow Jones fell 449 points, while gold had its biggest one day gain in 10 years.
- US government drafts plan to fight crisis - $ 700 billion, the biggest ever bail out plan
- Bush administration asked Congress for the ability to buy hundreds of billions in distressed mortgages (toxic assets)

Current State
Extraordinary events over the last few weeks

Sept. 20 : End of an Era

- The Fed Reserve announced that Goldman Sachs and Morgan Stanley, the last two big investment banks on Wall Street, would transform themselves into banking holding companies subject to far greater regulation.

Week ending Sept. 29
- Washington Mutual, the largest savings and loan institution of US, became largest bank failure in American history : regulators engineered an emergency sale to J P Morgan Chase.
- No Deal on Bailout. Dow Plunges by 778 points, $ 1.2 trillion vanish in a day.
- Citigroup Buys Wachovia Corporation, with the help of Federal Regulators, to rescue this large financial institution.

Current State
Extraordinary events over the last few weeks

Oct. 07

- Senate approves $ 700 billion bail out package.
- Europeon Officials debate need for bail out packages.
- House approves bail out on Oct 3.
- Financial Crisis Spreads to Europe:
  - German Govt promised to guarantee all private savings accounts.
  - Fortis was partially nationalized with Belgium, the Netherlands and Luxembourg investing a total of 11.2 billion euros
  - BNP Paribas, the French bank agreed to acquire Fortis, the troubled Dutch bank.
  - UK enhances the guaranteed bank deposit to 50,000 from 35,000.
  - Iceland nationalized it's third largest lender
  - European Leaders discuss discus Europe wide bail outs
  - UK announce GBP 50 billion cash injection in large banks (RBS, Lloyds & HBOS

Current State
Extraordinary events over the last few weeks

Oct. 015

- Global banks coordinate global rate cut.
- Rescue Plan Revised: $ 250 billion to be injected into banks to save them from collapse, including $ 25 billion each for four large banks.
- FDIC to offer unlimited guarantee on bank deposits in non-interest bearing accounts.

Current State
Extraordinary events over the last few weeks

Oct. 31

- Fed Cuts key interest rates
- Economy shrunk by 0.3%
- Fear of Deflation lurks as Global demand drops
- Fed lends AIG $ 21 billion
- 240,000 jobs lost in October

Current State
Extraordinary events over the last few weeks

Nov 08

- Obama won the presidency : facing towering To- Do list on Economy
- Jobless rate hits 14 year high, with unemployment jumping to 6.5%
- Total job losses in 2008 reach 1.2 million
- China unveils huge economic stimulus of $ 586 billion
- Another $ 150 billion package for AIG
- G-20 world leaders meet to discuss decide on strategy to revive economies- decide to work together
- Detroit Chiefs of three automakers plead for aid to stave off potential collapse

A Rapidly Changing Global Environment

Entities that have Failed include:	Entities that have been Acquired include	Entities that have been 'Rescued' include:	Entities that have Changed their business model include:

Current State

Cost of bail outs to-date

- **US government has pledged trillions of dollars to end the financial crisis:**
  - **Loans to the companies $ 1.7 trillion**
  - **Investments through share purchase and purchase of toxic assets $ 3 trillion**
  - **Guarantees of $ 3.1 trillion (government has issued guarantees in respect of corporate bonds, money market funds and deposit accounts.**
- **According to one estimate, the aggregate obligations taken by US government is $ 7.8 trillion (direct and indirect obligations) about half the size of US GDP. This amount far exceeds $ 700 billion that Congress authorized.**

Current State
Extraordinary events over the last few weeks (Cont'd)

• Last two weeks of October : Europe

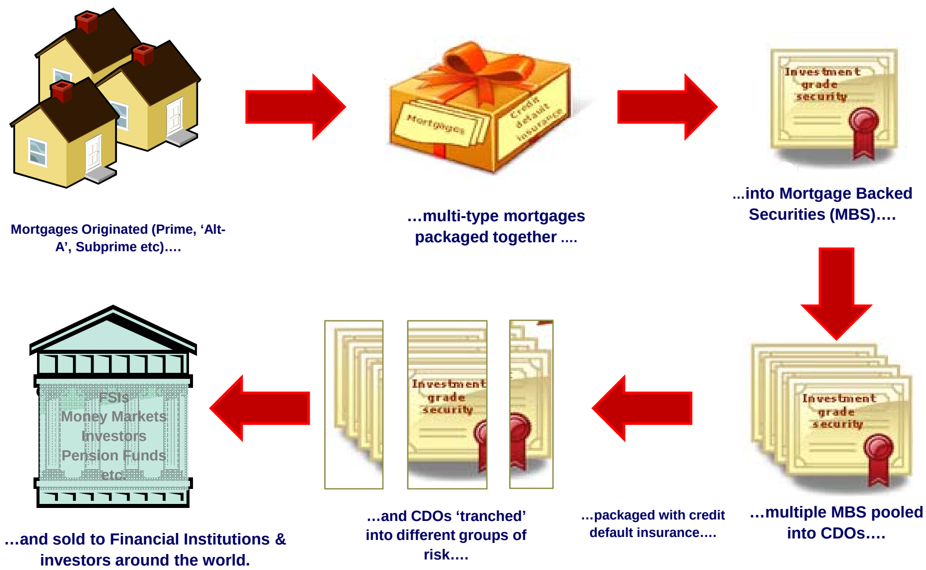
– Germany announced that it would guarantee bank debt to the tune of Euro 400 billion and supply an extra Euro 100 Billion to stabilize financial markets.
– France unveiled a Euro 360 billion package of measures, including Euro 40 billion for recapitalization of banks.
– Netherlands guaranteed Euro 200 billion in inter-bank lending.
– Austria, Italy, Spain, and others also produced several proposals.
– UBS, one of the largest Swiss banks also got a bail out, as Swiss government took a 9% stake in the bank and created a fund that allows UBS to offload $ 60 billion in toxic assets.
– Bank of Japan held an emergency meeting and decided to loosen up companies access to cash.

Current State
Extraordinary events over the last few weeks (Cont'd)

• Last two weeks of October

– Hong Kong provided blanket guarantee on all bank deposits.
– UAE pledged an extra $ 19 billion for its banks. Qatar said it would take stakes upto 20% in banks so that they could continue to fund regional infrastructure projects.
– US Federal Reserve took further measures to boost liquidity by unveiling a plan to provide up to $ 540 billion to support money-market mutual funds. (around $ 500 billion have so far been withdrawn from the market, which invests in commercial paper, certificates of deposits and other instruments).
– Mervyn King, governor of the Bank of England, issued his most down beat assessment yet of the British economy, asserting that "it was entering a recession".
– Euro fell to a two year low against dollar and pound dropped to a five year low.

Subprime Infects the Capital Markets



Complex instruments / terms

Derivatives : complex instruments

- **Weapons of mass destruction**
- **Total amount of derivatives $ 600 trillion (over 10 times of world GDP)**
- **Annual trade in derivatives in 2006 : $ 85 trillion compared to world GDP of $ 50 trillion.**

MBS (Mortgage based securities)

CDOs (Credit default options)

CDS (Credit default swaps) : type of insurance contracts to cover risk of defaults or credit risk derivatives

- **In 2007, the face value of CDS had reached $ 62 trillion compared to world GDP of $ 54 trillion. In October 2008 notional value of CDS had declined to $ 47 trillion.**
- **CDS generated large profits until the default rate started shooting up after sub prime crisis.**

Multiple factors responsible

- **Continuing boom over decades**
- **Low interest rates & Easy monetary policy**
- **Alan Greenspan**
  - Technological innovation leading to productively gains
  - Financial engineering through complex financial instruments
  - One in Century
- Continuous expansion over several decades
- Cheap goods from China (worlds manufacturing factory) resulted in steep increase in profitability and purchasing power
- Real Estate bubble expanded to beyond imagination

A Changing Industry Landscape (Oct 08)

Bank	Market Cap 08 ($bn)	Market Cap 07 ($bn)	Change
Citigroup	$78.4	$261.3	-70.0%
Bank of America	$100.8	$220.4	-54.3%
HSBC	$183.2	$214.9	-14.8%
ICBC*	$212.0	$209.1	1.4%
JPMorgan Chase	$135.1	$168.6	-19.9%
Bank of China*	$100.0	$157.3	-36.4%
China Construction Bank*	$156.0	$132.2	18.0%
UBS	$46.6	$128.3	-63.7%
Mitsubishi UFJ Financial	$80.7	$126.7	-36.3%
Royal Bank of Scotland	$30.6	$119.8	-74.5%
Wells Fargo & Co	$105.6	$117.4	-10.1%
Santander Central Hispano	$91.6	$114.1	-19.7%
BNP Paribas	$76.7	$109.5	-29.9%
Wachovia	$10.9	$101.3	-89.2%
Barclays	$37.8	$94.7	-60.1%
Intesa Sanpola	$55.0	$92.6	-40.6%
UniCredit	$43.9	$91.9	-52.2%
ABN AMRO	$92.2	$90.0	2.4%
Bank of Communications*	$42.8	$88.1	-51.4%
Credit Suisse	$43.8	$87.2	-49.8%
	$1,723.7	$2,725.4	-36.8%
	-$1,001.7		

Dropped out of Top 20 in FY08

Leads to Massive Writedowns

Public Financial Writedowns – as at September 2008

Firm	Writedowns	Capital Raised	Firm	Writedowns	Capital Raised
Citigroup	55.1	49.1	E*Trade	3.6	2.4
Merrill Lynch	51.8	29.9	Nomura Holdings	3.3	1.1
UBS	44.2	28.3	Natixis	3.3	6.7
HSBC	27.4	3.9	Bear Stearns	3.2	0.0
Wachovia	22.5	11.0	HSH Nordbank	2.8	1.9
Bank of America	21.2	20.7	Landesbank Sachsen	2.6	0.0
IKB Deutshce	15.3	12.6	UniCredit	2.6	0.0
Royal Bank of Scotland	14.9	24.3	Commerzbank	2.4	0.0
Washington Mutual	14.8	12.1	ABN Amro	2.3	0.0
Morgan Stanley	14.4	5.6	DZ Bank	2.0	0.0
JPMorganChase	14.3	7.9	Bank of China	2.0	0.0
Deutsche Bank	10.8	3.2	Fifth Third	1.9	2.6
Credit Suisse	10.5	2.7	Rabobank	1.7	0.0
Wells Fargo	10.0	4.1	Bank Hapoalim	1.7	2.4
Barclays	9.1	18.6	Mitsubishi UFJ	1.6	1.5
Lehman Brothers	8.2	13.9	Royal Bank of Canada	1.5	0.0
Credit Agricole	8.0	8.9	Marchsall & Ilsley	1.4	0.0
Foris	7.4	7.2	Alliane & Leicester	1.4	0.0
HBOS	7.1	7.6	U.S. Bancorp	1.3	0.0
Societe General	6.8	9.8	Dexia	1.2	0.0
Bayerische Landesbank	6.4	0.0	Caisse d'Epargne	1.2	0.0
Canadian Imperial	6.3	2.8	Keycorp	1.2	1.7
Mizuho Financial Group	5.9	0.0	Soverign Bancorp	1.0	1.9
ING Group	5.8	4.8	Hypo Real Etstae	1.0	0.0
National City	5.4	8.9	Gulf International	1.0	1.0
Lloyds TSB	5.0	4.9	Sumitomo Mitsui	0.9	4.9
IndyMac	4.9	0.0	Sumitomo Trust	0.7	1.0
WestLB	4.7	7.5	DBS Group	0.2	1.1
Dresdner	4.1	0.0	Other European Banks	7.2	2.3
BNP Paribas	4.0	0.0	Other Asian Banks	4.6	7.8
LB Baden-Wuerttemberg	3.8	0.0	Other U.S. Banks	2.9	1.9
Goldman Sachs	3.8	0.6	Other Canadian Banks	1.8	0.0
			Total	***501.4***	***351.2***

Where are we today?

- **Major institutions face failure, acquisition or government rescue**
- **Many entities outside of the financial services are affected as well**
- **U.S. Crisis is having a global impact – European institutions are suffering; emerging markets are slowing**
- **So far new capital insufficient to keep up with asset write downs**
- **IMF has estimated aggregate losses to due MBS / CDS etc. to the extent of $ 1.4 trillion.**
- **Bank of England estimates are $ 2.8 trillion till October for worlds top financial institutions. The amount could be much higher.**

Impact on Economy

- Real estate market continues to deteriorate, but at a slower rate
- De-leveraging in the financial services industry leading to recession
- As per latest estimates, US GDP contracted by 5% in the last quarter
- UK, Europe and Japan are also in recession : Japanese Exports declined by near 34%
- As factory to the world, China will be seriously affected due to collapsing global demand.
- Indian economy is also slowing down, with export cargo piling up and currency losing value. It is especially vulnerable due to its reliance on export of services

Impact on Economy

- There is a serious risk of deflation : in US, consumer prices fell by 1% in October, largest single fall since 1947.
- Most economist agree that the world is in its most serious financial crisis after great depression of 1930s.
- The impact on third world will be significant in terms of reduction in aid. The poverty and hunger will unfortunately rise.

Current State
Where are we today? (Cont'd)

- **Pressures are likely to grow for more transparent, simplified and standardized markets with fewer intermediaries**
- The burden of regulation is likely to increase as the price for government bail out increases
- Government responses to Issues unfolding around the world are similar
  - US government is currently working on another stimulus package of around $ 800 billion stimulus package, in addition to earlier packages
  - European financial and political leaders agreed to a plan that would inject billions of euros into their banks
  - Governments of many other countries have taken variety of measures

Dealing with the Crisis

Dealing With The Crisis
What can we expect?

- **Deleveraging --** Credit and asset price booms are typically followed by declines in asset prices and a process of deleveraging. This is happening already in the financial sector but corporates and households may join in.
- **Cash --** Corporates will find it harder to access external sources of capital – from banks, public debt markets and the equity market. Meanwhile economic activity and top line growth are slowing. In a tight-money, slow-growth environment - "Cash is King"
- **Risk aversion --** Cheap credit and strong growth encouraged risk taking. The credit crunch will lead to a sharp rise in risk aversion, and the sell off in riskier assets (e.g. high yielding bonds). "Caution is back in"
- **More business failures --** Unlikely to be restricted to financial services and banking as wholesale debt markets continue to tighten and differentiate between credit risks.

Dealing With The Crisis
What can we expect? (Cont'd)

- **Capital protection --** Investors are focussing more on capital protection rather than return on capital. The "flight to quality" and government backed securities
- **Balance sheet adjustments --** Balance sheet structures designed in the upswing may not work so well in downswing. Declining asset prices, rising interest rates and reduced credit availability have given corporates plenty of reasons to restructure their balance sheets.
- **Asset sales --** Many assets will change hand as corporates and consumers adjust to lower asset prices. Huge ownership changes are likely as cash flows from institutional investors, sovereign wealth funds and private equity to the sellers of assets. Since asset prices tend to undershoot in a downswing, just as they overshoot in an upswing, there will be bargains to be had

Changes in Accounting Standards

Fair Value Measurements – Permitted reclassifications

- IASB issued on October 13, 2008 amendments to IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 7 *Financial Instruments: Disclosures* that would **permit the reclassification of some financial instruments**.
  - introduce the possibility of reclassifications for companies applying IFRSs, which were already permitted under US GAAP in rare circumstances.
  - address the desire to reduce differences between IFRSs and US GAAP in a manner that produces high quality financial information for investors across the global capital markets.

	US GAAP	IAS 39 Amendments
Reclassification of securities out of the trading category in rare circumstances	Permitted	Permitted
Reclassification to loan category (cost basis) if intention and ability to hold for the foreseeable future (loans) or until maturity (debt securities)	Permitted	Permitted
Reclassification if fair value option previously elected	Not permitted	Not permitted

- **Click here for IASB amendments**
- **Endorsed by European Commission on October 16, 2008**

Changes in Accounting Standards

IASB amends IAS-39 to allow reclassification in certain financial assets.

Reclassification made to make the standard consistent with US requirements.

Scope of the amendments

- The amendments will only permit reclassification of certain non-derivative financial assets recognized in accordance with IAS 39. Financial liabilities, derivatives and financial assets that are designated as at FVTPL on initial recognition under the 'fair value option' cannot be reclassified.
- The amendments therefore only permit reclassification of debt and equity financial assets subject to meeting specified criteria.
- The amendments do not permit reclassification into FVTPL.
- Reclassification is allowed effective July 1, 2008.

Accounting Considerations in today's volatile markets

- **Determining Fair Values in inactive and illiquid markets**
  – IASB published guidance on "Determining Fair Values in inactive markets"
  – FASB / SEC have also published such guidance earlier.
- **Impairment testing of Goodwill and other tangible and intangible assets**

Dealing With The Crisis
Audit Considerations

So: How does the current situation impacts our Audits?

- Generally, nothing has changed in the Audit Methodology
- **But our clients' circumstances and the risks they face may have changed dramatically**

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- **Be aware of these (new) RISKS, respond to these risks accordingly and timely revisit our risk assessment**
- Make sure to apply Audit Methodology and applicable standards properly in all aspects of the audit

Dealing With The Crisis
Audit Considerations

- Consider **Specific Risks** due to the current financial crisis situation in the following areas (for all industries, not only financial services sector):
  - **Fair Value Accounting estimates**
  - **Material misstatement due to Fraud**
  - **Judgments over impairments of certain assets**
  - **Debt and debt covenants**
  - **Treatment of guarantees, commitments, contingencies**
  - **Going concern**

- Also consider the following:
  - **Completeness and adequacy of disclosures**
  - **Implications for on the audit report**

Audit Considerations
Fair Value Accounting estimates

- Understand the entity and its environment:
  - Understand the instruments in which the entity has invested or to which it is exposed, and the related risks
  - Understand the measurement process, including its complexity

- Design and perform procedures to respond to the assessed risks
  - Factors that may influence the risk assessment:
    - Entity's control procedures for making investment decisions
    - Level of due diligence management performs prior to investing in an instrument
    - Expertise of those responsible for making investment decisions
    - Entity's ability to value the instruments
    - Appropriateness of segregation of duties between those responsible for investment and those involved in investment valuation
    - Management's track record of assessing the risks

Audit Considerations
Fair Value Accounting estimates (Cont'd)

- Consider using the work of an Expert:
  - Consider including engagement team members sufficiently skilled and knowledgeable about fair value accounting
  - Determine the need to use the work of an expert
  - Obtain evidence that the work of an expert is adequate
  - Understand assumptions and methods used by an expert to consider whether they are appropriate and reasonable

Audit Considerations
Fair Value Accounting estimates (Cont'd)

- **BE CAREFUL:**
  - Challenges when fair value estimates have unobservable inputs, in particular as a result of illiquid markets:
    - Management may not have expertise internally to value illiquid or complex financial instruments
    - May be limited resources of information available to establish values
    - Assumptions might be necessary
  - Reliability of audit evidence is influenced by its source and nature:
    - Quote is obtained from institution that sold the instrument
      - May be less objective
      - May need to be supplemented with another evidence (other brokers or info from a pricing service)
    - May need to use independent model to compare its results with those of the model used by management
  - Changes in markets may require changes in valuation approaches

Audit Considerations
Fair Value Accounting estimates (Cont'd)

Fair Value Measurements – The Latest News:

- On September 30, the SEC's Office of the Chief Accountant and the FASB staff jointly issued a press release containing **questions and answers aimed at clarifying fair value measurement practices in the current market environment in the US, but questions can also be used outside the US**. The questions are as follows:
  - Can management's internal assumptions (e.g., expected cash flows) be used to measure fair value when relevant market evidence does not exist?
  - How should the use of "market" quotes (e.g., broker quotes or information from a pricing service) be considered when assessing the mix of information available to measure fair value?
  - Are transactions that are determined to be disorderly representative of fair value? When is a distressed (disorderly) sale indicative of fair value?
  - Can transactions in an inactive market affect fair value measurements?
  - What factors should be considered in determining whether an investment is other-than-temporarily impaired?
- **The IASB considers this clarification consistent with IFRS**

Audit Considerations
Fair Value Accounting estimates

- Obtain written management representation regarding the reasonableness of significant assumptions
- Communicate with those charged with governance the nature of significant assumptions and other related matters
- Evaluate if fair value disclosures are in accordance with the financial reporting framework

Audit Considerations
Material misstatement due to Fraud

At times of market instability, unexpected losses and financing difficulties create pressure on management who are concerned about the solvency of the business

↓

Incentives to engage in fraudulent financial reporting:

- to protect personal bonuses,
- to hide management error,
- to avoid breaching borrowing limits or
- to avoid reporting catastrophic losses.

↓

Increased Fraud Risk

Audit Considerations
Judgments over impairments of certain assets (Cont'd)

- Make sure you challenge and carry forward those conclusions reached in the prior years.
  - Are they still appropriate?
  - As the client's business changes, those conclusions could change…
- Ensure there is a sufficient documentation of or follow-up on triggering events and their impact on impairment
- Enhance professional skepticism in reviewing value in use computations for CGUs
- Review Adequacy of required disclosures

Audit Considerations
Debt and debt covenants

Entities that could be affected are those that are dependent on arranging refinancing over the coming months, or may be at risk of having current facilities withdrawn.

Ensure appropriate audit procedures are performed:

- To evaluate compliance with the debt covenants
- To evaluate if the entity will be able to refinance the current debt and / or continue utilizing a line of credit
- To understand the main terms of the debt agreement
- To review the debt instrument for embedded derivatives
- To evaluate completeness and adequacy of debt disclosures
- If necessary, consider the going concern assumption

Audit Considerations
Treatment of guarantees, commitments, contingencies

Consider the following:

- Appropriate accounting for and disclosure of written financial guarantee contracts (e.g. over loans affected)
- Appropriate accounting for and disclosure of commitments and contingencies especially commitments to provide funding or credit support.
  - Credit lines either being withdrawn or entities needing to honor calls for credit have been a recurring theme in some of entities affected by the current crisis
- Penalties for failure to complete transactions if relevant

Audit Considerations
Going Concern

When an entity is faced with deteriorating market conditions, there may be an increased risk that the entity is unable to continue as a **going concern**.

Consider the following factors:

- The effect of significant adjustments to assets stated at fair value or requiring provisions (e.g. on covenant ratios).
- The sources of finance, and whether they will continue to be available in current market conditions.
- Changes in the cost of finance.
- The effect of changes in markets on the ability to realize assets.

Audit Considerations
Going Concern (Cont'd)

Going concern factors (cont'd):

- Deteriorating markets in the entity's business.
- Sale of assets at significant losses may significantly reduce regulatory capital.
- Pending legal or regulatory proceedings against an entity engaged in selling financial instruments.
- The credit crunch is impacting significant customers or suppliers
- Deteriorating cash flows

Audit Considerations
Completeness and adequacy of disclosures

- The wording of forward looking statements within directors' report/chairman's statement/management commentary needs to be consistent with accounts and reality of entity's situation
- Do disclosures made within the accounts including but not limited to IFRS 7 adequately reflect the reality of the new situation an entity may find itself in? It has been evident that some press comment has focused on the fact that the published accounts of some of the companies affected gave no indication of their vulnerability
- Is there adequate disclosure of post balance sheet events where relevant in the context of what is proving to be a fluid and fast developing situation?
- Appropriateness of held for sale classification under IFRS 5 given effect of subprime issue on M&A activity

Financial Crisis Advisory Group

The Financial Crisis Advisory Group (FCAG) was established by the IASB and US FASB in response to the recent global financial crisis. Its purpose is to advise both boards about the role of accounting during the crisis and potential changes.

The FCAG has so far held two meetings.

Conclusion

- Key Accounting issues:
  - Fair Value and accounting estimates
  - Debt and Cash position
  - Going concern
  - Disclosures

- Risks from the recession situation
  - Receivables collections due to clients difficulties
  - Inventory obsolescence due to lower turnover sales
  - Deferred tax assets recoverability due to future losses
  - Pension plan assets and obligations valuation due to change in assumptions

Conclusion
What you should do now

- **Revisit risks assessment for all of your engagements**
- **Talk to your clients often and at the highest level possible**
- **Anticipate resolution of issues before year end**
- **Consult with experts and/or NPPDs whenever needed**
- **Look for opportunities to help clients, in full compliance with applicable independence rules**

Questions

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