10 QUESTIONS EXTERNAL AUDITORS SHOULD BE ASKING FINANCE DIRECTORS ABOUT LIBOR TRANSITION

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The London Inter-Bank Offered Rate (LIBOR) is one of the most important numbers in financial markets and is used in many financial arrangements including loans and derivatives. Therefore, the future discontinuation of LIBOR and its replacement with overnight risk free rates (RFRs) will be far-reaching. Given the significance of operational and financial change, the topic will be of significant interest to your external auditors. ICAEW's Financial Services Faculty highlights 10 questions financial directors can expect from their external auditors, from front to back of the audit lifecycle, over the next 18 months.

1. How well do you understand your firm's short, medium and long-term strategy and timeline for LIBOR transition?

Firms are expected to have taken action to analyse and plan for the impact of LIBOR transition. This often begins with firms performing exercises relating to exposure identification, data quality and monitoring. Regulated firms in the UK that fall under the Senior Manager & Certification Regime (SMCR) have additional regulatory scrutiny over action plans and milestones required in delivering a transition away from LIBOR. Understanding the impact of these milestones, targets, and actions from a finance perspective will be key in helping to drive and execute the transition strategy.

The impact on the audit approach will have to be considered as market conventions and regulatory target dates continue to develop. Firms may want to proactively address these changes with their auditors, as part of the audit lifecycle.

2. What system changes have you made (internal and external) to handle the transition, and how have you considered the design and effectiveness of related controls within the audit period?

LIBOR transition will, for many firms, necessitate the need for new or updated internal systems, or reliance on external system updates. For example, trade capture and booking systems will need to be updated or replaced to reflect the booking of trades referencing the new RFRs which have different characteristics to LIBOR.

Systems change brings with it a number of risks that firms and auditors will need to consider as part of assessing control environments, some of which will either directly or indirectly impact the financial reporting cycle (e.g. calculation of floating rate interest amounts for loans and deposits). In turn, it would be reasonable to expect auditors to do additional work over new or updated controls. This will be of particular interest for large and complex organisations where auditors may be required to opine on the internal controls over financial reporting.

3. How have you assessed the impact of transition on the appropriateness of your manual control framework?

LIBOR transition is likely to lead to short-term changes and amendments to existing manual processes and controls. For example, before new RFR-capable system updates are sufficiently implemented, firms may be using spreadsheets in order to manually administer newly originated RFR-linked trades. This type of manual intervention often gives rise to an increased operational and financial reporting risk.

There is generally a heightened risk of error associated with manual controls, when compared to automated controls, in particular if they have been newly introduced during the period. As a consequence, auditors are likely to challenge the appropriateness of new manual controls for example in their adequacy of mitigating risks and over the granularity and sufficiency of reviews performed as part of the controls. There may also be a knock-on impact on the auditor’s overall risk assessment and audit approach.

4. How have you considered the latest phase of amendments to IFRS, and will you adopt the expected changes early?

LIBOR transition gives rise to a range of accounting challenges, which to date have been the subject of much consideration by global accounting standard setters. Key accounting challenges predominantly relate to standards dealing with hedge accounting and financial instrument modification and de-recognition. It is also important to note LIBOR transition may impact various other areas of accounting that may currently use LIBOR as a discount rate.

Hedge accounting considerations include: 1) the ability to demonstrate that new hedge designations based on risk free rates are separately identifiable and reliably measurable, 2) the designation and effectiveness of hedges, 3) the impact of contract modifications on hedge accounting and the potential need for derecognition of hedges. The hedge accounting considerations will vary depending on the nature of the hedge relationships and are likely to be more extensive and complicated for macro (portfolio) hedge relationships.

The International Accounting Standards Board (IASB) has recently published an exposure draft proposing amendments that aim to address issues relating to financial reporting after the reform of a benchmark. The proposed accounting amendments offer certain reliefs for firms for some of the issues that LIBOR transition poses, not least helping to avoid excessive complexity and the need to break and re-designate hedges. Understanding the accounting impacts, and notably the timing and application of relief mechanisms, is important for firms to consider alongside their overall strategy to LIBOR transition.

Auditors are likely to query the extent of analysis performed by firms in understanding the impact of transition on accounting standards across classification and measurement, as well as the adequacy of disclosures. Engaging early with auditors on the application of expected relief mechanisms, and the basis upon which decisions have been taken, will be important in gaining sufficient understanding on the impact to the firm’s financial reporting cycle.

For firms that release interim reporting which is reviewed by auditors, there are likely to be questions regarding the accounting impact of trade modifications, if there have been any in the period, prior to finalisation and EU endorsement of the IASB Phase 2 amendments.

Refer to our separate “10 Questions” with respect to “Accounting and Disclosures” for further information.

5. To what extent have you reviewed your valuation policies in light of transition, and what updates are expected to be made?

LIBOR is used in the valuation of a wide array of financial instruments, including derivatives, cash products and pension scheme liabilities. The associated valuations are often material to a firm's financial statements and often included in the audit opinion as a key risk identified by auditors who prepare enhanced auditors reports.

As liquidity in RFR markets continues to grow and market conventions continue to develop, it is expected that ultimately, the associated market for LIBOR products will begin to decline. The liquidity of the LIBOR and RFR markets could impact fair values, fair value hierarchy classifications, the timing of recognition of day 1 profits and losses and the need for valuation adjustments. As a consequence, there could be a requirement to update related valuation methodologies, policies and procedures. There could also be a knock-on impact on the disclosures in the financial statements. This may require auditors to utilise more specialist valuation expertise on their audits.

6. Do you understand how LIBOR transition will impact your credit risk profile and outlook?

Many firms, particularly financial services firms, have significant credit risk exposures relating to the products held with trading counterparties. Some of these products will be linked to LIBOR either directly (e.g. referenced in contract), or indirectly (e.g. where the LIBOR curve is used as a valuation input for the product). LIBOR rates are credit sensitive, whereas RFR rates are, by their nature, risk free. Therefore, the transition of LIBOR products to RFR based products may impact key risk areas for auditors, such as expected credit losses within lending books and valuation adjustments for financial instruments held at fair value.

As market conventions across LIBOR currencies and RFR products continue to develop, and possibly diversify, auditors may seek to understand the extent to which firms have assessed the impact of moving away from a credit sensitive rate, to one which is risk free, along with the qualification of this impact from an IFRS perspective across the P&L and balance sheet.

Refer to our separate "10 Questions" with respect to "Conduct Risk" for further information.

7. Has your firm assessed and mitigated conduct risks that arise from the transition?

As many firms progress with transition planning and execution, it is critical that they are able to identify, understand and manage the conduct risks associated with transition. Information asymmetries, inadequate client disclosures and unmitigated conflicts of interest can all give rise to conduct risk throughout the LIBOR transition. The failure of firms to adequately plan for conduct risk identification and mitigation during LIBOR transition could be costly, as seen in previous mis-selling scandals. From a financial statements audit perspective, this increases the risk of a potential need for specific provisions or contingent liability disclosures, should issues relating to conduct risk and any associated litigation costs arise.

In assessing provisions and contingent liabilities, auditors may consider firms' governance and risk management frameworks relating to the transition and consider firms' product transition strategies, in order to independently consider if there is any related impact on the financial statements.

8. How have you considered the potential impact that LIBOR transition has on your tax position?

As LIBOR transition is expected to have legal contract, commercial, and accounting impacts, firms should also analyse the knock-on impact on their tax position. For example, this analysis could include taxable amounts arising from carrying value changes or 'disposal' events caused by

transition, or the ineffectiveness of hedge relationships as a result of transitioning to RFR products. There could also be an impact on transfer pricing agreements.

The resulting impacts will add complexity to the audit of tax balances, which may require increased use of specialist input for audit teams, particularly for international firms with a widely impacted product range, present in various tax jurisdictions and those with complex transfer pricing arrangements.

9. How will LIBOR transition effect your financial statement disclosures?

Financial statement disclosures in relation to LIBOR transition have started to materialise and are expected to increase throughout the transition, both qualitatively and quantitatively. For example, amendments to IFRS 7 introduced new disclosure requirements for hedging relationships requiring the disclosure of quantitative nominal amounts and qualitative information about the management of firms' transition programmes. The recent IASB exposure draft also contained proposals for additional disclosures relating to benchmark reform. LIBOR transition is also ultimately expected to significantly affect other existing disclosure requirements, for example those relating to market and credit risk.

Increased volumes and complexity of financial statement disclosure will likely increase the amount of focus and effort required to satisfy the accounting and audit standards. Early engagement between finance teams and auditors is important in order to understand the extent of disclosures required.

Refer to our separate "10 Questions" with respect to "Accounting and Disclosures" for further information.

10. How well does your firm understand the impact that LIBOR transition may have on your business model?

LIBOR transition is expected to affect the products offered to, and available for, customers and counterparties, leading to more complexity in the management of balance sheet risks. The size and scale of these risks may lead to changes in the firm's overall business model.

Auditors may wish to understand the extent to which firms have analysed the impact of business model change arising from LIBOR transition, and how this affects liquidity, funding and going concern considerations.

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