

# Financial risks and uncertainty in the current economic environment

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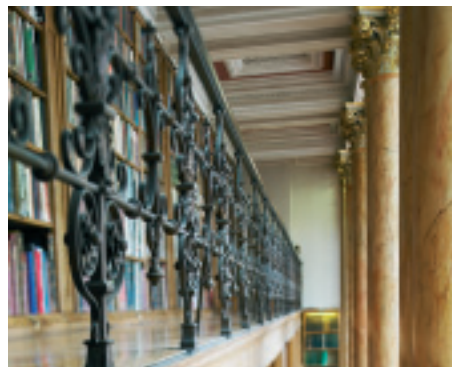
## Introduction

Liquidity, valuation, asset impairment and going concern are among the key areas of audit committee focus.

The global financial system has peered into an abyss, but has been pulled back from the edge by unprecedented intervention by governments worldwide. In Europe alone, policy makers have committed more than €1 trillion to banks in fresh capital for equity stakes and guarantees for bank funding and lending. It will take more time before we can be sure of stability – full transparency of exposures is still lacking, asset prices continue to fall, deleverage will continue and more capital is probably needed by the global banking system.

While opinions may vary about the magnitude or length of the current economic downturn, it is clear that the ongoing financial crisis will have a huge impact on the audit committee agenda for some time to come. Audit committees need to understand how the credit crunch and economic downturn has affected their company's business. From financial risks – such as liquidity, access to capital, valuation of assets and cash management – to strategic, operational, and third-party risks such as reliance on suppliers and other business partners, audit committees should consider reviewing management's plans to manage these risks.

Set out in the publication are a number of specific risk and going concern issues that audit committees might consider this financial reporting season. There are, however, other areas worthy of audit committee consideration. For example: is the audit committee satisfied with the quality, breadth and timeliness of the information produced by management; and is management's understanding of risk up to date? Events are moving very quickly and rolling forward the risk register from the half-year stage is unlikely to be sufficient.





## Key financial risks

Audit committees should be alert to the following array of financial risks and challenges that might arise in the months ahead, particularly in light of the ongoing credit crisis and economic downturn – both of which may exacerbate financial risks.

### **Ability to raise capital / liquidity**

- To what extent is the company dependent on short-term financing to operate?
- What are the company's plans with respect to raising debt and/or equity capital in the short- and medium-term, and how do current market events affect those plans?
- Have the company's sources of financing been disrupted by recent market events?
- Has management determined the impact of current market on its ability to dispose of its financial assets when necessary, at an acceptable price, to meet the planned repayment of liabilities?
- Is the company in default or at risk of defaulting on any of its debt covenants?

Audit committees should consider challenging managements' understanding as long-term banking relationships and drawdown facilities may no longer be relied upon. The rule book has, in effect, been torn up. One company with a large unused secured facility proposed entering into a cash raising transaction in order to increase its liquidity. On hearing of the potential disposal, the company's banker said that the facility would be withdrawn if this happened - with no renewal on any terms!

### **Deteriorating underlying investment and development property values**

- What is management's process for determining fair value and do the resulting valuations take sufficient cognisance of current conditions in the property market?
- Do valuations of investment property take adequate account of expected rental income, changes in expected yields, the impact of renegotiated lease incentives or any other special assumptions relevant to the property?
- What are the key assumptions and judgements applied in assessing the carrying value of development properties or land held for future development and how have assumptions been updated or revised to address issues such as extended development time horizons, estimates in relation to future selling prices, changes to expected cost inputs, changes to market discount rates? Are the assumptions applied independently verifiable?
- To what extent has reliance been placed on independent valuations, what caveats were included in the valuers reports and has a financial appraisal of the applicable caveats been undertaken?

- Has sufficient sensitivity analysis been undertaken to adjust for foreseeable changes in key assumptions?
- Has the impact of changes in financing arrangements such as the inclusion of equity participation features or depleted equity in structured vehicles been factored into assessments of risk and reward – does the balance of risk and reward now lie with the financing bank?

#### **Impairment of goodwill and intangible assets**

- What is the basis for estimating future cash flows?
- Are the projections consistent with budgets and plans?
- Was recoverable amount based on fair value less cost to sell (i.e., assuming future disposals) or value in use (i.e., assuming continued trading)?
- Do estimates take account of the current economic environment and specifically those key issues impacting on the sector in which we operate?
- What head room is left between carrying values and the recoverable amounts as calculated? What sensitivities have been assessed i.e., by flexing the discount rates applied and/or other assumptions?
- Do the disclosures provide sufficient clarity?
- Are the implied multiples in our calculations consistent with recent/historic deals?
- Have the results of our calculations been reconciled to current market capitalisation and the differences where carrying values exceed market capitalisation been reasonably understood?

#### **Impairment of investments and other financial assets**

- Has management given appropriate consideration as to whether any significant or prolonged decline in the fair value of investments in equity instruments below cost represents objective evidence of impairment that should be recognised in the income statement?
- Has management given appropriate consideration to those triggering events that may warrant impairment assessments in the current period?
- Are the fair values of financial instruments determined by the company (by models) realistic based on current market conditions or were they based on historical assumptions that may no longer be consistent with valuations that potential buyers would ascribe currently?

#### **Pensions asset valuations and funding**

- How will changes in financial markets impact the valuation of pension plan assets and mandatory or desired funding requirements?

### Market turbulence

- Net yields have increased by 90 to 120 basis points over 2008, driving pension liabilities down by around 20 percent - 25 percent. For a scheme invested 60 percent equities/40 percent bonds, assets may have fallen by 15 percent.
- Bond yields have moved by up to 0.15 percent and equities by up to nine percent in a single day.

### Impact on accounting results

- Balance sheet positions at 30 September 2008 may have improved due to sky-high corporate bond yields.
- Bond re-ratings in the coming months could lead to balance sheet deterioration.
- Forward looking P&L charges are higher than for 2008 due to higher inflation expectations and lower asset values companies should consider P&L mitigation options in advance of the year end.

### Financial assumptions

- Anomalies in corporate bond data are leading to a large spread of discount rates.
- Many companies are likely to adjust data for "credit crunch" conditions.
- Lower inflation assumptions can be justified for shorter term liabilities.
- A lower discount rate could be combined with a term specific inflation assumption to be balance sheet neutral but have a positive P&L impact.
- Current conditions could justify a higher expected equity return, boosting the forward looking P&L financing credit.

### Counterparty default

- Has management considered the potential exposures to other entities that are experiencing severe financial difficulties, or whose parents are experiencing severe financial difficulties?
- Has management considered the legal treatment of contracts or other arrangements involving an entity falling into administration or liquidation?
- Has management decided whether to terminate (or substitute) swaps or other derivative contracts with entities that are experiencing financial difficulties?
- Were any such derivatives or other contracts automatically terminated as a result of counterparty default?
- Will there be disruptions to securitisations or similar vehicles sponsored by an entity that now finds itself in severe financial difficulties?

### Ability to hedge commodity costs

- What will be the impact of inflation or recession on commodity costs and procurement strategies?
- How will any changes impact the ability to obtain economic hedges and what will be needed to enable qualifying hedge accounting under IAS 39?

### Restructuring or curtailing of capital expenditures

- In the event of a deep recession, what restructuring is being considered by the company?
- What capital expenditures should be deferred?

### Identification of risk

- How does the current market affect the company's liquidity, leverage, and risk profile?
- How does the company assess risk, and should risk assessment methodologies change as a result of recent events?
- Is the audit committee alert to the increased risk of inappropriate earnings management, as well as the risk that budget cutbacks may be 'excessive' and adversely affect the long term performance of the business and the quality of the finance function?

Attendees at recent global ACI events overwhelmingly identify risk management and the quality of risk intelligence as one of their top concerns. Many audit committees and boards want a better understanding of the processes used by management to identify and assess significant strategic, financial, and operating risks. At the same time, they are sensitive to the risk of missing the 'big picture'.

### Operational risk

- Have recent market events highlighted unexpected risks that management was not previously aware of?
- Have recent events confirmed or highlighted any weaknesses in established trading strategies?
- Has management put in place necessary arrangements to cover any unexpected funding needs and avoid any breaches of covenants or regulatory requirements?
- Have recent market events increased the likelihood of litigation against the client?

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With the speed of events over recent months, it is important that management consider whether current market conditions have resulted in material uncertainties.

## Going concern

In more benign market conditions, management's review of the going concern assumption has been a relatively easy exercise. However, with the speed of events over recent months, it is important that management consider whether current market conditions have resulted in material uncertainties that cast significant doubt over the company's ability to continue as a going concern. Some examples of material uncertainties include:

- To the extent they are not covered by the Government Guarantee Scheme, inability of lending banks to honour existing facilities.
- Undue reliance on hitherto strong relationships with lending banks.
- Difficulties with re-financing when existing facilities mature - automatic renewals should not be assumed.
- Difficulties with re-financing after covenant breaches triggered by not meeting financial statement measures or other tests.
- Uncertainty as to future trading forecasts and projections on which re-financing plans are based.
- Dependency on future asset sales to stay within facilities (for example sales of property which cannot be assumed to happen as in the past).
- Dependency on a significant customer and the risk of such a customer terminating the arrangement where no long term contract is in place or it is no longer in a position to honour such a contract.
- Dependency on a significant supplier and the risk that they fail to meet their commitments endangering our clients business without a contingency plan in place.
- The range of variability of an estimate (e.g., a litigation claim) in difficult times may affect going concern.
- Insurance company unable to meet claims in relation to risks management assume to be insured.

Audit committees may wish to consider challenging the assumptions used by management in cash flow forecasting models and the validity of models used for the forecasts to ensure in particular that recent economic and market conditions have been appropriately factored in. The accuracy of previous forecasts is also important as is ensuring the forecasts cover a period of at least twelve months from the date of approval of the financial statements.

## Audit issues



External auditors are likely to need to change the nature, timing or extent of audit procedures to respond to the risks arising from current market conditions and the impact on the availability of sufficient and appropriate audit evidence, particularly in certain sectors such as banking, construction and property development and other related or dependent businesses. In certain circumstances:

- The fair value of assets may no longer be obtainable by reference to prices in active markets, resulting in the need for management to rely on complex valuation models with many unobservable inputs.
- The measurement, presentation and disclosure of certain assets and liabilities and/or the appropriateness of the going concern assumption may be dependent on management intent and ability to carry out certain actions.
- Disclosures in the financial statements may use data from systems and models whose inputs cannot be easily observed under current market conditions.
- Disclosures of risk and matters of judgement and/or uncertainty will be subject to greater scrutiny from stakeholders

Changing the nature, timing or extent of audit procedures to appropriately respond to increased risks may involve:

- Assigning more experienced staff or staff with special skills.
- Providing more supervision of staff.
- Consulting with (say) valuation specialists.
- Performing procedures closer to the period end.
- Updating procedures performed and audit evidence obtained on significant matters up to the date of the auditors' report.
- Corroborating evidence obtained by seeking more third party evidence.
- Increasing the extent of testing by increasing sample sizes or changing selection criteria such that more items are selected for testing.

# Ten To-Do's for Audit Committees in 2009



When considering and carrying out their 2009 agendas, audit committees should...

**1 Closely monitor the impact of the financial crisis/recession on the company; focus on financial forecasts and early-warning indicators.**

Understand the recession's impact on the company's earnings, cash flow, liquidity, and compliance with debt covenants, and monitor key indicators of trouble. Recommend that management assemble a crisis management team to monitor the impact of the crisis on a "real-time" basis, and to develop (and stress-test) worst-case scenarios.

**2 Assess the company's exposure to third parties in financial distress.**

Ensure that management is monitoring the impact of the crisis on the company's key customers, suppliers, insurers, partners, banks, underwriters, counterparties, and other third parties that may be experiencing financial difficulty (or have filed for bankruptcy). An up-to-date inventory of the company's potential exposure to third parties is essential.

**3 Understand the impact of the financial crisis on the company's financials - particularly the balance sheet.**

Focus on the company's investment portfolio, including debt and equity securities, to identify declines in value or impairments that should be reflected in the financials. Help ensure that management has identified possible impairments of goodwill, deferred taxes, patents, and other intangibles, and that fair values determined by management and valuation experts are reasonable. Assess how changes in financial markets have impacted the valuation of pension plan assets and funding requirements.

**4 Focus on fair value and liquidity disclosures.**

Understand the company's disclosure processes for fair value accounting and liquidity issues - and how the application and impact of fair value accounting is described in the Comprehensive Business Review and other periodic filings. Consider whether the description of the company's liquidity risks is sufficiently robust and specific to the company.

**5 Make sure your risk discussions with management are healthy and productive.**

With the benefit of hindsight and possible "lessons" from the financial crisis, consider the adequacy and effectiveness of the company's governance processes for managing risk (management's processes and the board's). Be a catalyst in helping to pose the right questions, including: Can management provide a holistic view of the company's major risks - both on and off the balance sheet? Are the top risks facing the company understood and agreed upon? How rigorously does management stress-test key risk assumptions? Are the board's information sources sufficiently varied and objective? How does culture - including incentive compensation - impact the company's risk profile?

## 6 Help the company and the board prepare for change.

With the financial crisis and globalisation changing the world in dramatic ways (a less-leveraged economy, a restructured banking/finance industry, potentially more regulation and shareholder activism on issues like executive compensation, new business models driven by technology, globalisation, and competition - and more), step back and consider what the emerging business environment will look like. Does management understand how this new environment will impact the company's risk profile, and the viability of its strategy and business model?

## 7 Take a hard look at opportunities to improve the audit committee's effectiveness.

Count on increased expectations for good governance and effective oversight, and focus squarely on opportunities to improve. Pay attention to the basics - like having the right mix of committee member experience and skill sets, committee independence and leadership, an understanding of the company's strategy and financial risks, and the adequacy of support for the audit committee. If you don't get the basics right, your ability to ask the right questions and challenge management is severely limited.

## 8 Be sensitive to the strains on the finance director, internal auditor, and finance organisation.

In this highly-charged business environment, the demands of the financial crisis, liquidity and cash flow issues, possible resource constraints, and pressures to meet performance expectations have all exacerbated the normal rigours of the director's and finance team's jobs. Recognising their critical role in guiding the organisation through the financial crisis, support them by helping to maintain the focus on long term financial performance, injecting objectivity into financial disclosures, and ensuring the finance organisation has the right expertise and resources (including the budget) to do their jobs well in this tough environment.

## 9 Expand the audit committee's information sources.

Consider whether the information the audit committee receives comes from a balanced variety of sources (versus relying too heavily on information from management), and whether the information flow promotes sufficient internal transparency (versus fragmented or partial views). Getting the right information is essential to providing an effective oversight of the company's financial reports, its risks, internal controls, and finance team.

## 10 Monitor the tone from leadership and throughout the organisation.

For most companies, 2009 will likely be a year of tremendous pressure and change - and a good measure of uncertainty. In this environment, it is more important than ever to be acutely sensitive to the tone from - and the example set by - leadership, and to reinforce a culture of compliance and a commitment to financial reporting integrity throughout the organisation.

## About the Audit Committee Institute Northern Ireland

The Audit Committee Institute Northern Ireland (ACINI) was established in 2005 to serve audit committee members and help them to adapt to their changing role. Sponsored by KPMG, the ACINI exists to help audit committee members enhance their awareness, commitment, and ability to implement effective audit committee processes.

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