

Considerations Related to the Current Financial Crisis

The current turmoil in the financial markets presents all audit committees (not just audit committees of financial services companies) with the critical challenge of understanding how the financial crisis affects their company's risk profile. From liquidity and access to capital, to fair value and asset impairments, and ultimately, to the adequacy of the company's processes to manage these and other risks effectively, audit committees are focused on the risks their companies are facing in the current environment. Here are some critical risks—and key questions—that audit committees should consider:

Liquidity and access to capital. What are the company's plans to raise debt / equity in the short and medium term? How dependent is the company on short-term financing? Are credit lines secure? Is the company at risk of default on debt covenants?

Ability to hedge against interest rate, currency, and commodity price volatility. What will be the impact of inflation and recession on commodity costs and procurement strategies? How will changes impact the ability to obtain economic hedges against interest rate, currency, and commodity price volatility?

Exposure to counterparties and other third parties in financial distress. Have we inventoried the company's potential exposure to third parties in the United States and internationally—e.g., customers, suppliers, banks, lenders, underwriters, guarantors—that are experiencing financial difficulty or have filed for bankruptcy? Has the company identified the impact on contracts and other arrangements it has with these entities?

Additional Resources

Defining Issues®, October 2008, No. 08-37: Fair Value Measurements in Inactive Markets www.kpmg.com/aci/DI.asp

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Fair value and asset impairments. Have we reviewed the company's investment portfolio and inventoried its debt and equity securities to identify declines in value or impairments that should be reflected in the financials? Have we identified triggering events that may warrant impairment assessments of goodwill, deferred taxes, patents, and other intangibles? (If so, are the fair values determined by management and valuation experts realistic in light of current market conditions?) How have changes in financial markets impacted the valuation of pension plan assets and funding requirements?

Disclosures. How is the application and impact of fair value accounting described in the MD&A? Is the description of the company's liquidity risks robust and specific to the company?

Threat of a deep recession. What restructuring is the company considering? What capital expenditures should be deferred, given the prospects of a retracting economy?

Reassessing Risk

As a result of the financial crisis, many boards are reassessing the adequacy and effectiveness of the company's governance processes for managing the risks to the business. Most everyone agrees that there's a need to improve the way companies manage risk; but *how* to accomplish that is a matter of ongoing debate. While no one has all the answers, it is critical to ask the right questions, including:

- Can management provide a holistic view of the company's major risks—both on and off the balance sheet risks? What are the top five risks crossing all parts of the business?
- How tolerant is management of risks? Does management understand that a catastrophic risk that poses even a “less than 1 percent” chance of failure for the enterprise is unacceptable and must be avoided or mitigated to the extent possible?
- How rigorously does management stress-test key risk assumptions?
- How frequently does management review the risks associated with its products, particularly high-growth and high-margin products?
- Are the board's risk-related information sources adequate *and varied*? Is there sufficient internal transparency?
- How does culture—including the incentive compensation structure—impact the company's risk profile?

The business environment has changed dramatically, and we will likely see more changes—perhaps a new wave of legislation and regulation, a less leveraged economy, continued volatility of commodity prices and markets, and greater expectations for effective oversight. For boards and audit committees, understanding the company's risk profile—and improving governance processes for risk management and oversight—should be a top priority.