Across the Board

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Financial risks and uncertainty

in the current economic environment

Cashflows and liquidity, unrecorded liabilities, asset impairment, going concern and valuation are among the key areas of audit committee focus.

The ongoing global economic crisis and credit crunch have resulted in many economies facing recession; the failure of major financial institutions; and financial difficulties for many companies, including major international manufacturing companies. For Thai companies, the impact of the global crisis has been exacerbated by the recent political tensions in Thailand, including the temporary closure of the Bangkok International Airport, which have had an adverse effect on tourism, and international trade and investment.

While opinions may vary about the magnitude and length of the economic downturn, it is clear that the credit crunch in the United States and Europe will have a huge impact on audit committee agendas across a wide range of industries in South East Asia. Audit committees need to understand how the credit crunch and the emerging global recession have 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 reassessing the adequacy and effectiveness of the company's governance processes for managing the risks to the business.

Set out in this publication are a number of specific risks 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 risks affecting businesses are changing on a day by day basis.

Key Financial Risks

Audit Committees should be alert to the following array of financial risks and challenges that may 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

- 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?

Audit committees should consider challenging managements' understanding as long-term banking relationships and drawdown facilities may no longer be relied upon. Management is required to understand default provisions in current borrowing requirements and evaluate alternative ways of structuring the current credit facility. The rule book has been in effect torn up. Banks have become more cautious about credit quality. Borrowings are now taking place at higher interest rates and with greater collateral requirements. Financial institutions are increasingly focused on the recoverability of loans and minimizing bad debts.

Impairment of investments and other assets

- Has management given appropriate consideration as to whether any significant or prolonged decline in the fair value of investment in equity instruments below cost represents objective evidence of impairment that should be recognized in the income statement?

- Has management given appropriate consideration to those triggering events that may warrant impairment assessments in the current period?

The volatile market conditions faced by businesses have introduced significant additional pressure on the judgements needed to assess illiquid asset values. In light of the global economic downturn and ongoing volatility, audit committees are expected to want a better understanding of these judgements and more detailed analysis than in previous years.

Counterparty default

- Has management considered the potential exposures to other entities that are experiencing severe financial difficulties, or whose parent companies 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 terminated during the reporting period as a result of counterparty default?

Ability to hedge against interest rates, currency and commodity price volatility

- What will be the impact of inflation and recession on commodity costs and procurement strategies?

- Can the company employ smarter procurement techniques?

- How will company's ability to obtain economic hedges against interest rate, currency exchange rate, and commodity price volatility be affected?

Failure to take advantage of opportunities to reduce tax liabilities

- Has management reviewed fixed and leasehold assets in order to ensure that each is depreciated over the correct time period for tax purposes?

- Has management taken advantage of the new depreciation rates for corporate income tax purposes in accordance with Royal Decree 473 effective from 7 August 2008? For example an immediate tax depreciation deduction of 40% can be taken against the cost of machinery and equipment and a tax deduction for the residual 60% over the following five accounting periods.

Restructuring or curtailing of capital expenditures

- In the event of a deep recession, what restructuring is being considered by the company to supply the customer in the lowest-cost way?

- What is the level of expenditure spent on business support services? and is this appropriate?

- What capital expenditures should be deferred?

- How effectively are creditor payments being managed? Is there any more action that can be undertaken without damaging relationships with suppliers?

Disclosures of significant accounting and reporting judgements

- Is the audit committee satisfied that consideration has been given to post balance sheet events up to the date of the approval of the annual accounts? Are there any unfavourable trends in asset values or cash flows that require disclosure?

- Is the audit committee satisfied that appropriate disclosure has been made of write-offs and potential write-offs of goodwill resulting from current economic conditions, including information about key assumptions and analysis? Has the audit committee considered whether any identified impairments could be either insufficient or excessive?

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 International ACI events overwhelmingly identified 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

Audit committees should consider challenging managements' understanding as long-term banking relationships and drawdown facilities may no longer be relied upon. Other questions they should also review include:

- 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 arrangement 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 company?

Pensions asset valuations and funding

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

Going Concern

In more stable market conditions, management's review of the going concern assumption has been a relatively easy exercise. However, with the speed of events in 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 that audit committees should consider include:

- 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 single 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 the company's business
- 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.

The audit committee may wish to consider challenging the assumptions used by management in the cash flow forecasting models and the validity of the models used for the forecasts. The accuracy of previous forecast is also important as is ensuring the forecasts cover a period of at least twelve months from the reporting date. Further considerations include:

- Has the audit committee considered the process in place to ensure that appropriate procedures and controls have been applied to the preparation of cash flow and valuation information, including the consistent application of key assumptions?
- Is the audit committee satisfied that the cash flow models have subject to independent review by for example internal audit?
- Is the audit committee satisfied that a sensitivity analysis has been undertaken to check assumptions and identify how accurate the cash flow model is? For example have relationships with third parties including suppliers been considered aswell as the potential for any third party defaults been taken into account?

More information

Audit Committee Institute (ACI) Thailand is sponsored by KPMG in Thailand. The Institute's primary mission is to serve as a forum and dedicated resource to keep Audit Committees (AC) informed of regulatory matters, company law and accounting and auditing issues. Ultimately, the Institute seeks to enhance the AC's awareness of, commitment to, and ability to discharge their responsibilities. To learn more about the Audit Committee Institute Thailand or to access our resources, please visit *www.acithailand.org* or e-mail us at auditcommittee@kpmg.co.th

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