

BoardMatters Quarterly

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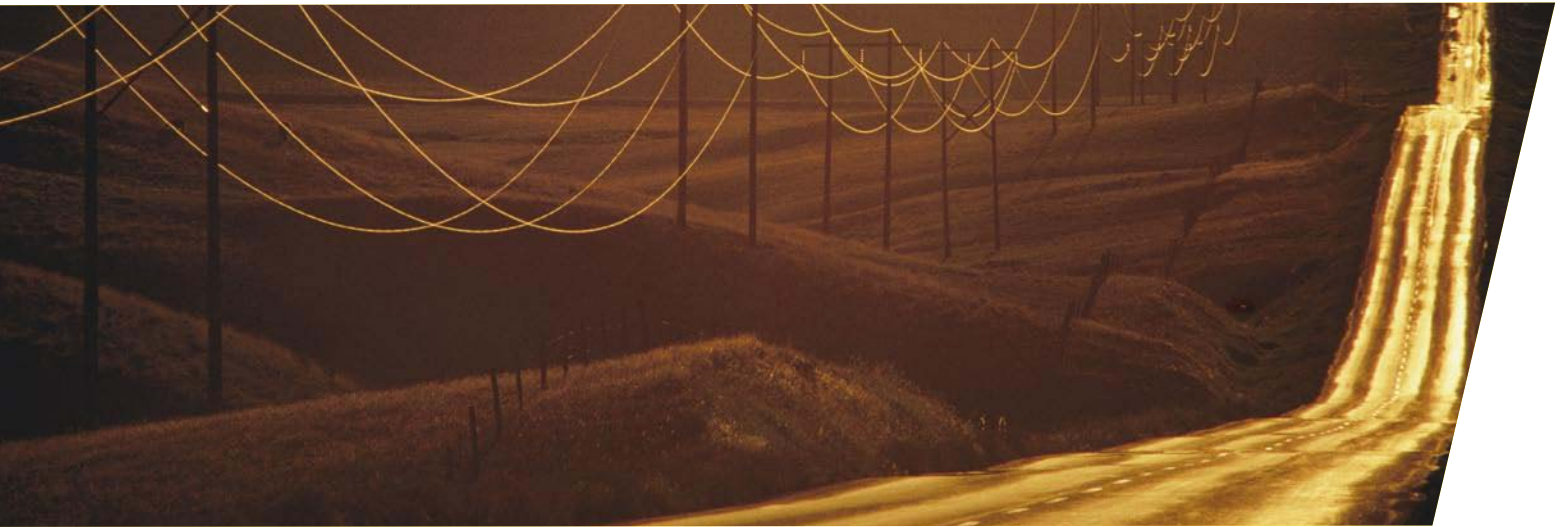
Managing risk in the current climate

As we begin 2009, there are few indications that the current economic conditions will ease in the near future. Instead, most signs suggest that things might worsen before the markets stabilize. This issue of *BoardMatters Quarterly* is dedicated to helping audit committees identify, prepare for and protect against the key risks that their companies may face during these challenging times. With this market turmoil has come an increased focus on enterprise risk, fair value accounting, liquidity and counterparty risk, and we hope our perspectives on these topics help your audit committee further prepare to weather the financial storms ahead.

Please feel free to contact us with your feedback on this issue of *BoardMatters Quarterly* or with your ideas for future issues. We encourage you to share this information with your colleagues and ask that you let us know of others who would benefit by receiving this publication. Send your feedback to Lindsey Romes at lindsey.romes@ey.com.



Managing through a downturn



It is no surprise that recent events in the financial markets topped audit committee agendas in 2008 and will continue to do so in 2009. Steep adjustments in real estate values, rising unemployment, limited ability to obtain new capital and liquidity concerns created downward pressure on asset values and unrest in the capital markets. These unprecedented conditions introduce many challenges for companies and their management, many of whom predict continued issues before the markets stabilize.

Market implications

Without a doubt, virtually all industries are, or will be, affected by the current economic environment. The sluggish pace of economic activity has been accompanied by rising unemployment that continues to weigh on consumer sentiment and spending. In addition, amid falling house prices and rising foreclosures, activity in the housing sector continues to decline. Plunging business sales and profits are restraining capital spending.

Many companies have already been forced to recognize asset impairments, restructure their operations and recognize declining fair values,

particularly for illiquid or complex financial instruments. Coupled with rising unemployment rates and tightening credit availability, the effects are far reaching, with economic slowdowns arising in global markets.

Audit committees are continuing to evaluate whether sufficient attention is being given to the amount of risk assumed across various operating, investing and financing activities. Specific areas of concern for audit committees to discuss with management and auditors include: risk management, compliance and the potential for fraud, fair value measurements, liquidity and capital resources and asset impairment, as well as the related disclosures.

Audit committee areas of focus

Risk management

In an unstable economic environment, protecting the company from excessive risk is a top priority for management and the audit committee. When it comes to risk management, there are many areas of concern that audit committees should consider while discussing financial reporting issues with management and auditors. The audit committee should understand to what extent the company is susceptible to financial, operational or strategic exposures and assist in developing and overseeing the company's plan to address the identified exposures. In light of current market

events, audit committees need to be aware of changes management makes to the risk management strategy and whether appropriate internal controls are in place to support these changes. Additionally, audit committees should understand if management has changed the scope of its annual assessment of internal controls over financial reporting and review its assessment of the performance of internal controls.

Ethics, compliance and the potential for fraud

Accompanying today's challenging economic environment is an increased risk of unethical behavior and the potential for fraud. Fraudulent financial reporting often results from pressure to meet financial objectives relative to reported earnings or specific financial requirements relating to debt covenants and earnings to cover interest charges. Companies often design corporate compliance programs to achieve compliance with laws and regulations, internal policies and procedures and contractual obligations. The audit committee should carefully assess the possibility for fraudulent financial reporting and the effectiveness of the company's corporate compliance programs.

The current environment has undoubtedly increased the pressure to meet earnings predictions and financial requirements around debt covenants and interest charges. Schemes to perpetrate financial reporting fraud include improper accounting for transactions with related parties and special purpose entities, manipulation of management estimates of fair value relating to real

estate assets and financial instruments, and more traditional schemes, such as management of "cookie jar" reserves, and improper revenue accounting as a result of undisclosed side letter agreements and bill and hold arrangements. The audit committee should understand the application of accounting principles to company transactions, particularly those that are unusual in magnitude, frequency or with unknown counterparties.

Management communications and effective corporate compliance programs serve to prevent unethical or illegal behaviors. The audit committee should consider the geographies and cultures in which the company operates so that it can evaluate the effectiveness of compliance programs across the full breadth of the company's operations. While this is particularly important for companies with global operations as they face increased scrutiny from regulators relative to their compliance with the Foreign Corrupt Practices Act, it also pertains to companies with specific regulatory requirements in industries such as healthcare, financial services, utilities and those that have government contracts.

In today's environment, not only does the audit committee need to consider the effects of economic circumstances and pressures, it also needs to maintain constant awareness of ethical standards, the quality of corporate compliance programs and the possibility of fraudulent activities leading to inaccurate financial reporting.

Fair value measurements

Difficult market conditions, coupled with the implementation of Financial Accounting Standard Board (FASB) Statement No. 157, *Fair Value Measurements* (Statement 157) and FASB Staff Position No. 157-3, *Determining the Fair Value of a Financial Asset when the Market for that Asset is Not Active*, have increased the spotlight on fair value accounting. For many companies and audit committees, the implementation of Statement 157 has created unexpected challenges – particularly the considerations regarding fair value when illiquid markets exist. Accounting standard setters, financial statement preparers and users, regulatory agencies and lawmakers continue to debate fair value accounting, holding vastly different views about how fair value is used as an objective measure in financial reporting.

Given that the market for many instrument types has become more illiquid, coupled with the required implementation of Statement 157, the practical application of fair value accounting is more complicated than originally expected. Fair value accounting issues can be difficult and have been exacerbated by existing market conditions. As a result, management faces new challenges that often require the application of significant judgment and audit committees should understand these judgments. Further discussion about fair value accounting and the related challenges facing audit committees at year end are outlined in "Fair value accounting: The debate continues" on page 6.

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Liquidity and capital resources

As the volatility in the market continues and financial institutions tighten their lending practices, companies with both long-term and short-term debt that is expected to be replaced, refinanced or renegotiated may encounter issues accessing capital. These risks may be heightened for companies that are highly leveraged, experiencing a market decline or have declining results from operations. For this reason, audit committees should review management's analysis of liquidity and capital resources to understand what lines of credit are up for renewal and what debt is expected to be refinanced and how.

The audit committee should understand if the company is in compliance with its debt covenants and if there is a risk that it could be out of compliance in the next 12 months. Historically, lenders may have been more willing to provide waivers for debt covenant violations; however, due to current market conditions, these waivers may be more difficult and costly to obtain. If a waiver is needed and cannot be obtained, this could trigger default. Additionally, the audit committee must recognize if the company is dependent on the ability to renew or obtain new financing or capital in order to fund cash requirements for at least the next year. If so, this could raise ongoing concerns and doubts about the company's ability to continue as a going concern.

Disclosures

Audit committees need to consider how the company's disclosures reflect current market conditions through all types of media, including filings, websites, conference calls and press releases. Furthermore, they will need to understand how management has addressed the United States Securities and Exchange Commission (SEC) staff's recommended fair value disclosures. Areas where the company may need to increase disclosure include the company description and risk factors, critical accounting policies and estimates, and liquidity and capital resources. It is important to closely monitor reporting requirements as the expectation for additional or more specific disclosures could evolve based on the depth of current issues.

Other issues

A decrease in product demand, lower-than-expected earnings or disrupted cash flows could mark a change in the business climate that is an indicator of, and could result in, asset impairments of long-lived assets, intangible assets or goodwill. Additionally, as has always been the case, audit committees need to understand any new or unusual transactions or financial structures such as sales of assets or transactions with related parties. The committee should also be aware of any changes to key assumptions or estimates in light of current market events. For example, have changes been made in pension or other postretirement benefit plans,

forecasted results, sales returns, cash flows, asset impairments or allowance for doubtful accounts? If so, what changes were made and what was the result? Some companies experiencing liquidity issues may be forced to lower prices on inventory to move the product and raise necessary cash. Changing levels of inventory in the current environment, even if historically consistent, may signal demand issues in the marketplace, giving rise to valuation issues.

The speed at which problems have spread in the last few months reflects how changes in the interconnected financial markets can occur rapidly. Companies and audit committees should monitor significant events that occur after the balance sheet date and before the date of the auditor's report – financial statements should be adjusted for any material changes in estimates during that period. For example, the bankruptcy of a customer subsequent to year end could materially affect the adequacy of the allowance for doubtful accounts and require the allowance to be adjusted in the financial statements. Other types of significant subsequent events, such as additional credit or liquidity restrictions, may require disclosure in the financial statements.

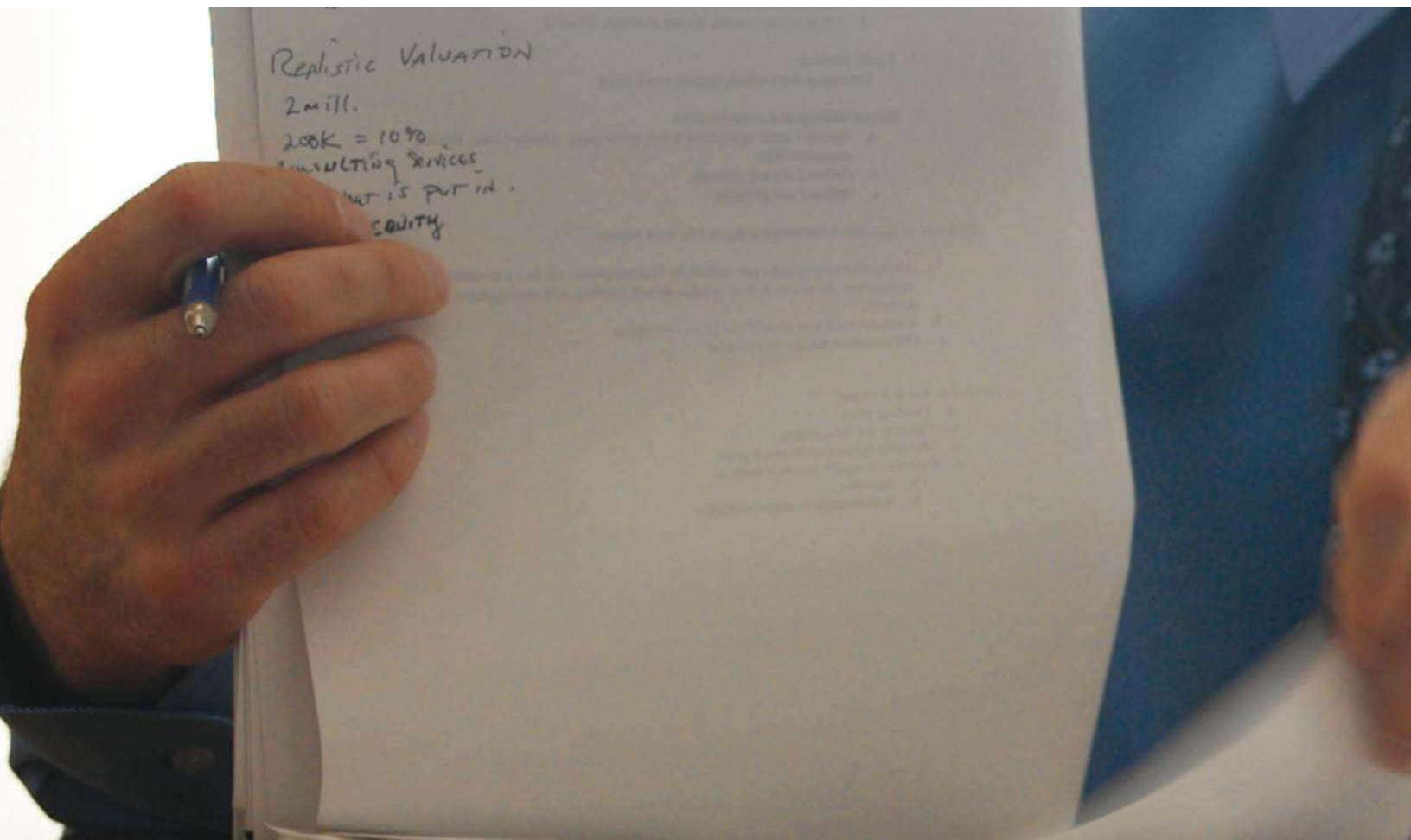
As audit committee members monitor the unstable economic environment, maintaining an awareness of potential issues and acting with timely and appropriate responses will help them fulfill their fiduciary responsibility and enable the company to prepare better for the uncertainties that lie ahead. ✓

Questions for the audit committee to consider

- ▶ What changes has management made to address the identified financial, operational and strategic risk exposures related to the growing set of credit, liquidity and valuation issues?
- ▶ Has management changed the scope of its annual assessment of internal controls over financial reporting? If so, how?
- ▶ How have the company's internal control processes and procedures been impacted by personnel cutbacks or other cost-cutting measures?
- ▶ Has the company assessed its internal control systems relative to corporate compliance (with respect to laws, regulations and internal policies) and anti-fraud measures, including the Foreign Corrupt Practices Act?
- ▶ Has the company received any information questioning its business practices or reported financial results (i.e., comment letters from regulators, concerns expressed by internal or external auditors relating to internal control or accounting matters, inquiries from analysts about operating results and disclosures, or from hotlines or whistleblowers)?
- ▶ Has the company entered into any transactions that are unusual as to contractual form, size of transaction or with different counterparties, and which might not be appropriately monitored by company processes and controls?
- ▶ What methodology has management utilized for determining fair value, particularly for complex or illiquid securities? Have there been any changes in the methodology used by management given the current volatility in the marketplace?
- ▶ Has the company evaluated the fair value of other investments such as money market funds, commercial paper, municipal securities, mortgage and other asset-backed securities?
- ▶ Are operations dependent on the ability to raise capital or maintain debt?
- ▶ Is the company in compliance with its debt covenants? If yes, is there a risk that it may be out of compliance in the next 12 months?
- ▶ What disclosures has management changed to address the company's critical accounting policies, market risk, liquidity and capital resources? How has management's discussion and analysis (MD&A) been modified to address these matters?
- ▶ Has management made changes to key assumptions or estimates in preparing the financial statements in light of the current market events and business operations? If so, what changes have been made?
- ▶ In the company's cash flow projections, how soon is the company projecting a recovery and what is the substantiation for that timing?
- ▶ Has a reforecast of the business outlook or increased cost of capital in the market affected the potential recoverability of goodwill?
- ▶ Has the company evaluated the continued creditworthiness of its customers and the effects the current market conditions may have had on them?
- ▶ Has the company experienced higher than desired levels of inventory? If so, are there demand issues that may indicate inventory valuation issues?

Fair value accounting

The debate continues



Few topics are generating as much discussion across the business community as fair value (or “mark-to-market”) accounting. Rarely discussed during good times, the fair value issue has ignited controversy across the globe as accounting standard setters, financial statement preparers and users, regulatory agencies and lawmakers debate the topic.



The debate surrounding fair value accounting continues to swirl in an environment marked by uncertainty, as participants hold widely divergent views about if, when and how fair value should be used as the measurement objective in financial reporting. Issues deliberated range from whether an observed price in the current market represents a reasonable basis for financial reporting to if the use of fair value accounting should be suspended entirely. While discussions continue

among various influential stakeholders, including the Financial Accounting Standards Board (FASB), International Accounting Standards Board (IASB), United States Securities and Exchange Commission (SEC) and governments from various geographies, businesses world-wide must apply existing fair value requirements to many assets and liabilities and provide disclosures so that financial statement users better understand the extent and effect of fair value measurements on the entity.

Although FASB Statement No. 157, *Fair Value Measurements* (Statement 157), has been the focus of much of the recent debate, the use of fair value is not a new concept and has been required or permitted for decades under many different accounting standards. Issues associated with the use of fair value accounting can often be complex, and existing market conditions have made determining fair value measurements for certain financial instruments more difficult. Accordingly, management faces new challenges that often require the application of significant judgment and audit committees should understand these judgments.

Today's issues

As 2008 financial results are finalized, it is apparent that the application of Statement 157 and FASB Staff Position No. 157-3, *Determining the Fair Value of a Financial Asset when the Market for that Asset is Not Active*, have proven to be more complex, and the practical implementation of their principles more challenging, than many had initially expected. Estimates indicate that nearly 200 different pieces of US accounting literature refer to fair value and from this vast array of topics many implementation issues requiring judgment on the fundamental principles of Statement 157 have surfaced. Accordingly, audit committees should discuss the areas in which significant judgment was applied in the adoption or application of Statement 157, as well as some of the significant conceptual, operational and practical issues encountered by management.

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Given the level of complexity and judgment associated with certain fair value measurements, the vital information included in disclosures allows users of financial statements to understand and assess the effect of these measurements on the results of operations and financial position. The disclosure of fair value information is not constrained to the notes of the financial statements, and should also be discussed in other areas of an SEC filing. Accordingly, audit committees should understand how management intends to communicate the use of fair value measurements in the periodic filings with the SEC. For example, fair value information may reside within management's discussion and analysis (MD&A), including the liquidity and capital resources, risk factors and critical accounting policies portions of MD&A. When evaluating how management intends to present fair value information, the audit committee should consider how management addresses and discloses the secondary effects of reporting assets and liabilities at fair value in the current environment, including:

- ▶ Exposure to violations of debt covenants, lenders withdrawing financing commitments or an increase in funding requirements for a pension or postretirement benefit plan
- ▶ Difficulty navigating and accessing the capital markets
- ▶ Regulatory complications
- ▶ Effects on planned mergers and acquisitions or capital spending

Tomorrow's concerns

Due to the relatively recent adoption of Statement 157, comment letters by the SEC staff regarding the application of, and disclosures related to, Statement 157 have been limited. However, once the 2008 financial reporting season closes, the SEC staff will begin reviewing the first audited financial statements reflecting the application of Statement 157. In this economy, fair value measurements likely will be an area of focus for the SEC staff. The SEC staff has already expressed certain views regarding useful disclosures in two "Dear CFO" letters issued in 2008.¹

To date, the application of Statement 157 has been limited primarily to financial assets and liabilities. Still, the use of Statement 157 in the current environment has caused a number of challenging issues related to financial instruments. Undoubtedly, additional implementation issues will arise when applying Statement 157 to non-financial assets or liabilities beginning in 2009. For example, the adoption of FASB Statement No. 141 (revised 2007), *Business Combinations*, will expand the number of items measured at fair value at the acquisition date in a business combination. Audit committees should discuss with management how the application of fair value accounting to non-financial assets and liabilities will interact with the new business combination rules.

The debate around the use of fair value accounting has been vigorous, with strong opinions and a wide range of views. Given the economic climate, it is difficult to forecast the future of the fair value accounting debate; however, the SEC presented the results of its study on fair value accounting to Congress in late December 2008.² With the heightened level of interest in the business community around fair value accounting, and the fact that potential changes may arise, audit committees and other interested parties should closely monitor the activities of standard setters, regulators and legislators regarding fair value. ✓

¹ In addition to the SEC's required disclosures, in March and September 2008, the SEC staff issued "Dear CFO" letters to certain registrants that identified additional disclosures regarding assets and liabilities measured at fair value that entities may wish to consider when preparing the MD&A section of their SEC filings. Although the letters were primarily issued to financial institutions, the SEC has indicated that the comments apply to other organizations as well. The letters issued by the SEC staff are located on the SEC's website, along with other fair value materials, at sec.gov/spotlight/fairvalue.htm.

² As part of the Emergency Economic Stabilization Act of 2008, the SEC was required to perform a study of fair value accounting. In support of this study, the SEC has hosted a series of public roundtables with a broad range of representatives to solicit feedback on a variety of fair value-related topics. Information regarding the roundtables and the SEC's study of fair value accounting is located on the SEC's website, along with other fair value materials, at sec.gov/spotlight/fairvalue.htm.

Further considerations

When finalizing financial reporting for fiscal year 2008 and preparing for fiscal year 2009, audit committees should consider the following:

- ▶ Which areas required management to exercise extensive judgment such that its decisions had the potential to significantly affect a fair value measurement? How did management evaluate whether the positions taken were reasonable in the circumstances and the resulting value was representative of an exit price consistent with the objective of Statement 157?
- ▶ What entity-wide changes were required to address the application of Statement 157 (e.g., new or amended accounting policies and internal control processes, hiring of additional internal or external expertise)?
- ▶ Are any of the disclosures suggested by the SEC staff in the “Dear CFO” letters applicable to the entity? Would the information be of benefit to users of the financial statements?
- ▶ As the effective date for the application of Statement 157 to non-financial assets and liabilities approaches, how will management assess the effect of the new requirements? Have any significant issues been identified and, if so, how does management plan to resolve those matters?
- ▶ How does management understand, evaluate and monitor the potential effects of changes to the fair value accounting standards? Is management active in the standard-setting process?

Cash flow crisis?

Managing cash and treasury functions is more important than ever

The volatility and turmoil in the capital markets has forced companies to focus more on cash, working capital, liquidity management and the role of the treasury function. The treasury function is traditionally responsible for aligning the company's liquidity strategy to support the company's current circumstances with appropriate levels of cash, access to credit, and cash receipt and payment terms. As the market continues to fluctuate daily, treasury departments are finding their policies around risk and liquidity management to be increasingly scrutinized by management and audit committees.



Current credit, liquidity and valuation issues have made cash management a regular audit committee agenda topic, regardless of industry. As audit committees rethink their role in cash management and treasury processes during extreme financial events, they also want to know if, and how, management has developed appropriate measures around monitoring cash and working capital. Existing treasury policy and governance requirements may not have considered the need for diverse banking relationships in the case that any one of the banks reduced the committed credit line, was downgraded or failed. Yet, the past few months have shown that even with the US federal government bailout plan, the lending landscape has changed drastically.

Additionally, current treasury policies and requirements may not have fully considered the safety of the company's funds in its banks and investments. While it is unlikely that treasury policy and governance directives would have allowed companies to experience the current market events unscathed, such directives could have given companies greater comfort and direction and the tools to manage through the crisis.

As the financial turmoil continues, it is apparent that many companies need to revise and upgrade their current treasury governance processes. Specific areas to address include:

- ▶ **Increased communication and visibility** – A company's treasury-related risks need to be more visible. The treasury function needs to be in regular contact with the business units in order to sufficiently measure, manage and synthesize risk and better report it to senior management, the board and audit committee. When the risks are visible and understood by the

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board, senior management and the board are able to be proactive in their approach – making sure the company is properly compensated for the risks it takes and challenging treasury to manage and properly identify the risks. Finally, senior management and board involvement makes sure that treasury risks are incorporated into and measured against the company's enterprise-wide risk program.

- ▶ **Defined risk policies and procedures** – Clearly defined policies and procedures that describe the types, tenors and volumes of risk a company can accept, along with the risk management and reporting requirements business units must follow, help control the risk profile and volatility of a company's earnings and cash flow.
- ▶ **Outside objective input on risk** – Companies often view the assumption of additional risks on a client contract or business expansion program as a marketing incentive or a necessary cost of doing business. These decisions are often made at the business unit

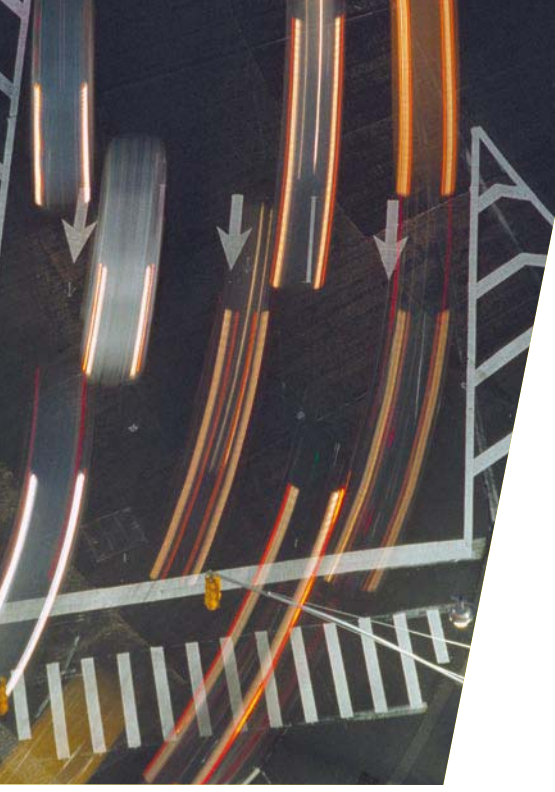
level and, due to inadequacies in the company's risk reporting systems, are not always identified specifically as risk. Many companies find that by using outside risk advisors, they can find embedded risk, understand how other companies manage risk and counsel the board or audit committee better and more efficiently than they could on their own.

- ▶ **Relevant technology to the governance process goals** – Too often technology decisions are made at a management level and the board or audit committee cannot be sure the information systems are able to support the controls of the company. Boards or audit committees should have enough involvement in technology issues to determine that the company's information systems are able to provide management with the necessary data to support its decision-making and governance role. For example, does the company have robust accounting and financial systems to consider downside

scenarios in cash flow forecasting? Does the system include measures to monitor cash and working capital and how often is the audit committee updated on these measures?

Swift action by treasury departments on critical cash management and liquidity issues has the potential to improve and strengthen financial performance. In the current economic climate, companies need to manage cash better and improve cash flow forecasting. The monitoring and oversight of cash, working capital and liquidity are vital in the face of prolonged market turmoil as cash may be the company's last lifeline. Finally, the audit committee and the board must have a clear view of the risks assumed by the treasury function in order to understand the risk the company is entering into and the potential effect on its earnings and cash flow. Though an increased role in the treasury function may be new for some boards and audit committees, cash flow is an area of vital importance to the company and cannot be overlooked. ✓

- ▶ Has the company revised or upgraded its current treasury governance processes?
- ▶ What steps is the company taking to manage cash better and improve cash flow forecasting?
- ▶ Should the company diversify its banking relationships?
- ▶ Are the company's funds safe in the banks where they are invested? If the company placed collateral with a financial institution, is it safe?
- ▶ If banks reduce the company's uncommitted financing lines, how could the lines be replaced?



Counterparty risk

Lessening your company's exposure

By design, contracts provide security to both parties in a business arrangement and mitigate the risk that their agreement will not be honored. Ironically, a risk that remains ever-present is counterparty risk: the risk that a party will not, or cannot, honor the contract. Once a negative counterparty risk exposure outcome transpires, it is already too late. But what role can the audit committee play in keeping companies safe?

What is counterparty risk and who is affected?

Counterparty risk – the risk to each party of a contract that the counterparty will not live up to its contractual obligations – has become a mounting concern for a very good reason. Its effects are being witnessed on a grand scale at the core of the current economic crisis. These events have prompted many questions from companies that have derivative relationships with counterparties in various degrees of financial distress, ranging from widening credit spreads to the bankruptcy filing of the counterparty. Yet the issues go much further than just derivatives and the bankruptcies that have been highly publicized. Evaluating counterparty risk is an important element in assessing fair value. Often there is no overall guarantor because the parties presumed that the other side was creditworthy, would honor any losses and would continue as a going concern. Other companies tried to reduce counterparty risk by insuring the transaction and transferring the risk to the insurers. Ultimately, the subprime mortgage debacle has taught the world a lesson in counterparty risk exposure and what happens when a contracted insurer cannot pay.

Because counterparty risk exists in every contract, it spans all industries. On some level, contracts can be considered links in a chain that connect businesses to other businesses – they are pervasive and exist anywhere from the procurement of office supplies to financing operations. A negative outcome can have a cascading effect that extends far beyond the original contracted parties. In the consumer products sector, for example, the credit crisis is hurting suppliers and distributors, and affecting parties deep within the supply chain (such as retailers) who are making changes to payment terms to cope with declining commodity prices. It's no wonder that counterparty risk has been termed as a "contagion" by some analysts.

Most organizations are actively identifying and evaluating all of their counterparty risks. For example, if a company has a municipal security investment with a credit wrap from a monoline insurer (i.e., financial guarantee company) and the monoline has been downgraded or is no longer in existence, there is additional risk with the monoline. Other types of counterparty risks include guarantee features in place when a company entered into a contract that may no longer be in existence and

could also pose new risk. The company needs to evaluate the specific contract in order to assess whether there is any new counterparty risk.

Investments in joint ventures (JV) are another example. A company could be involved in a venture with a partner that is no longer able to perform, creating implications for the company. Other partnering arrangements, such as those in the technology sector for software or hardware development, can also have counterparty risk exposure. For instance, if a semiconductor manufacturer is unable to deliver chips on time, it can pose significant problems for its customer. While the tardiness may seem like a mere annoyance, the chip provider could significantly delay its customer's ability to deliver the product to market. The end-user customers can be left waiting months for the latest technology, and the company is left competitively vulnerable. Rather than continuing to allow the chip provider to threaten its bottom line, many companies identify multiple sources of components so as not to rely on one vendor.

One key contributor to counterparty risk is that contracts are negotiated based on information available during

a snapshot in time. In the previous example, the company has no reason to think the reputable chip provider would be unable to deliver on its contract as specified. While contracts are brokered based on good faith and a great deal of consideration for creditworthiness, liquidity, market standing and economic conditions, these factors can change at any moment, increasing risk exposure.

Counterparty risk will always be a part of business relationships. However, there are measures that can be taken and questions to ask when beginning contractual negotiations to mitigate risk exposure. For instance, the oil and gas sector is exposed to counterparty risk through commodities and futures trading. Presently, US\$9 trillion of commodities are traded off-exchange, and much of this over-the-counter (OTC) trading leaves parties open to risk that normally would be considered acceptable. However, in light of the credit crisis, many are opting instead to conduct trade contracts using clearinghouses that guarantee their trades in an effort to lower the risk profile.

The company should know if there are multiple related entities involved in a contract and whether there are counterparty risks related to financial transactions not on the books, such as with leases or purchase supply agreements. Understanding these types of issues and having policies, procedures and controls that keep the company within the parameters of acceptable risk exposure are essential.

The audit committee's role in counterparty risk mitigation

The audit committee's experience with counterparty risk need not be limited to an after-the-fact downstream assessment following a negative outcome. By its very nature as an oversight body, the audit committee can drive greater care and scrutiny to better incorporate counterparty risk exposure into the company's risk management activities. This can be accomplished by asking management the right questions and motivating them to remain focused on managing business relationships. Increased attention to risk exposure is a good place to start.

Audit committees can help manage counterparty risk by examining the controls and processes in place to identify counterparty risk. Also, they can ensure management evaluates the current level of counterparty risk exposure on a regular basis, with increased attention during "ripple effect" periods such as this current credit crisis. In addition, audit committees can confirm that counterparty risks are adequately disclosed in financial statements.

Certainly, counterparty risks can have consequences that are severe, but not every situation is a crisis. In the end, all business activity contains some level of risk. While audit committees should be attentive to the risk levels of the company, management should not let the presence of counterparty risk freeze the business into a state of scared inactivity. Management must operate with the knowledge that counterparty risk is always there – awareness is an important first step in determining risk exposure. ✓

Considerations for the audit committee

- ▶ Does management have a thorough understanding of the company's exposure to counterparty risk?
- ▶ Does management use a process to understand and evaluate the company's counterparty risks? Is management proactive in dealing with counterparty risk issues?
- ▶ How does management educate the audit committee on the potential counterparty risks? Has the non-performance risk of counterparties been adequately assessed?
- ▶ Have the company's internal controls functioned effectively with respect to counterparty nonperformance risk?
- ▶ Has management fully disclosed, as appropriate, its counterparty nonperformance risk?
- ▶ How have the company's peers and competitors been affected by counterparty risks?
- ▶ How does management identify and raise awareness of potential issues beyond the accounting function?

Enterprise risk oversight

New considerations for the audit committee

During the final quarter of 2008, as the financial crisis deepened, the focus of public companies turned from a finger-pointing blame game to fear about what to expect. “What’s next?” became the big question. In the midst of this crisis, regardless of the industry, audit committees began taking a fresh look at their companies’ approach to enterprise risk and considering ways to enhance board oversight of the risk management process. Here are their top concerns – and what they are doing about them.

Concern #1: The most devastating risks come from where no one is looking

Trying to think of, and prepare for, the unexpected is a challenge for management and boards alike. Audit committee members voice concerns about a narrow, business unit-specific view of risk. They also worry that management can be too retrospective in its analysis of what could go wrong, without sufficient consideration of new, prospective risks.

What they are doing about it:

- ▶ Focusing on the top risks associated with the financial crisis; 18 months ago, no one saw the potential for the liquidity crisis to reach the scale that the world’s markets now face. Today, as noted throughout this issue of *BoardMatters Quarterly*, audit committees are routinely reviewing their companies’ liquidity, access to credit, ability to refinance and concentration and counterparty (including insurer) risks. Analyses

of key stakeholders – customers, suppliers and joint-venture partners – have become more extensive, and the key findings are more often discussed with audit committees.

- ▶ Continuing to ask out-of-the-box questions to identify risks. One audit committee chair said, “I try to ask the unthinkable, look at what could be catastrophic.” Others have highlighted the importance of being able to identify “red flags.” For example, the performance of any business has a historical pattern – say, its return on equity. Audit committees can keep an eye on this pattern and, if it changes significantly, ask management to explain.
- ▶ Adding to the industry expertise in the boardroom. Critics have highlighted the lack of industry experience in financial services’ boardrooms, and how this may have contributed to the current crisis. Boards are now likely to bring in directors with industry experience to address these concerns.

- ▶ Ensuring management adopts a balanced approach to risk identification. Bottom-up approaches focus on the business risks identified by line management, which are then aggregated across the company. Conversely, top-down approaches focus on strategic risks, as identified by senior executives and the board. A comprehensive approach to identifying risks combines both approaches.

Concern #2: No link between compensation and risk appetite

Policymakers, regulators and investors have singled out executive compensation and other incentive programs as undermining the necessary balance between risk appetite and risk controls.

What they are doing about it:

It is not difficult to argue that, in some cases, compensation structures have encouraged overly risky actions by management. With pay being a recurring theme in the discussion of financial and other crises, it is likely we will see



more board and committee involvement in compensation decisions. Boards are cautious about being too heavily involved in target-setting or the selection of performance metrics, but are considering ways to link pay with risk. Potential solutions include linking executive compensation directly with the top risks a company faces, longer term incentive pay programs or implementing risk-adjusted pay programs. At a minimum, audit committees are recognizing that they should work with the compensation committee to understand their companies' executive compensation programs in order to assess the potential effect on the company's overall financial risk profile.

Concern #3: Access to sufficient risk expertise within the audit and compliance functions

Internal and external auditors play a role in assuring a company has a rigorous approach to risk management, as do compliance and legal professionals. However, audit committee chairs sometimes question whether their

internal audit teams have the appropriate skill-sets to take a leadership role in identifying key risks. According to some audit committee chairs, they are also concerned that compliance professionals may not be sufficiently skilled to help their organizations anticipate and adjust to a much more regulated marketplace, an outcome that is increasingly likely.

What they are doing about it:

Audit committees are more frequently inviting internal and external audit teams to a joint discussion and analysis of the company's major risks. This discussion can take place either separately with the audit committee chair or as part of the audit committee meeting. For specific risk issues, such as reputational risk, audit committees may use specialized consultants. Within this context, audit committees value external auditors for their objectivity and industry-wide perspectives.

Now that we are in a recession, many companies are naturally retreating to a more fiscally conservative mode

of operation, with greater emphasis on mitigating risk. Audit committees can play a leading role by helping management be proactive about assessing financial risks and by acting as a catalyst to enhance the board's approach to enterprise risk oversight. In this regard, there are three key areas of focus for the audit committee in 2009:

- ▶ Encouraging the company to develop a rigorous approach to identifying risks
- ▶ Addressing the linkage between compensation and risk appetite
- ▶ Ensuring there is sufficient risk expertise within the audit and compliance functions. ✓

Forward View is written by Tapestry Networks. Views expressed by Tapestry Networks are those of Tapestry Networks and not necessarily of Ernst & Young. Tapestry Networks convenes seven audit committee networks sponsored by Ernst & Young that collectively consist of more than 100 individuals, who chair more than 125 audit committees and sit on over 200 boards at some of the world's most admired companies.

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Effectiveness and accountability in the boardroom

Kellogg School of Management Corporate Governance Program

May 3-6, 2009, Evanston, Illinois

This two-and-a-half-day directors' program, in collaboration with Ernst & Young, will focus on developing the skills and strategic insight needed to become a more effective director. Led by top faculty from the Kellogg School of Management, corporate board members will learn frameworks that can move the board from compliance exercises to designing opportunities for long-term value creation.

Directors will develop a deeper understanding of board governance, master the ability to strategically respond to boardroom dynamics and study the legal and ethical challenges faced by today's boards. Optional sessions feature improving financial literacy and understanding the board's role in mergers and acquisitions.

To request more information on this ISS-RiskMetrics accredited program, please contact Nicole Schneider at + 1 847 467 7037 or n-schneider@kellogg.northwestern.edu. ✓

Measuring audit committee effectiveness

The Ernst & Young Online Audit Committee Self-Assessment Tool

One way the audit committee can gauge success in its oversight role is through its annual self-assessment. The self-assessment provides valuable information for the audit committee and the board of directors by identifying areas where the committee is proficient and where it needs to improve in order to fulfill its oversight objectives. The results of the self-assessment can also help the audit committee determine where to focus its efforts during the upcoming year.

The Ernst & Young Online Audit Committee Self-Assessment Tool allows up to 15 people (e.g., audit committee members, chairman of the board, CFO, CEO, internal audit) to participate in the self-assessment process. However, a minimum of three individuals must submit a self-assessment for the committee to receive company-specific and benchmarked reports. Users of the self-assessment tool will be able to benchmark their committee's results against an aggregate of other company self-assessment responses by such categories as total responses, public or private company, revenue tier and number of employees. Self-assessment responses are kept confidential and only Ernst & Young professionals responsible for the self-assessment tool have access to your individual responses.

To participate in the Ernst & Young Online Audit Committee Self-Assessment Tool, please contact Sara Czarka at + 1 216 583 1031 or sara.czarka@ey.com and you will receive a reply within one business day. ✓

This issue and other Ernst & Young audit committee resources are available online at www.eyonline.com/auditcommittee.

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