Issues of the day for Boards and audit committees

Ernst & Young's Mak Keat Meng and Glenn Daly highlight some of the issues that are topping the agendas of Boards and audit committees.

Mak Keat Meng, Head of Assurance
Glenn Daly, Partner, Business Risk Services
Ernst & Young Solutions LLP

The faltering economic conditions in global capital markets and tightening of credit flow witnessed in 2008 have left many companies facing profit erosion or losses by the close of the year. Not surprisingly, increased scrutiny by investors and stakeholders has heightened the pressure and spotlight on Boards and audit committees (ACs).

Charged with oversight responsibilities over most, if not all, aspects of the business, Boards and ACs find themselves confronted with new challenges, or old fundamentals that have assumed unprecedented significance. Pertinent issues ranging from financing to financial communications to risk management and controls, are expected to continue to be extensively discussed and debated in the boardroom.

Treasury And Investments

With exposures to financial instruments hogging headlines, liquidity and valuation issues remain vital concerns for most companies. This calls for Boards and ACs to sharpen their focus on the company's working capital, and look into revising or upgrading their treasury governance processes where necessary.

Swift action by treasury departments in managing and forecasting cash flow is critical to financial performance. The lines of communication between Board, ACs and the treasury department should be kept open. Boards and ACs need to consider carefully the safety of the company's funds in its banks and investments, and ensure they are informed of treasury-related risks, which should rightfully be incorporated into the enterprise-wide risk program. It is also timely to review the company's investment portfolio and policy to clearly define the types and volumes of treasury risk a company can undertake.

In addition, Boards and ACs should advise management to exercise prudence and patience in seeking new acquisitions or opportunities, and re-assess significant expenses in 2009.

Risk Management

Protecting the company from excessive risk continues to be a top priority. Getting risk management right often requires re-visiting the fundamentals.

The Board is ultimately responsible for ensuring that management has established adequate risk management policies and systems to safeguard shareholders' investment and company assets. A basic, yet critical, governance consideration is whether the AC is adept at reviewing the adequacy of the risk management process in the company, or if a separate risk committee with the right composition and experience, or even an external advisor is necessary.

In addition, it is important that the company's risk management framework recognizes a broader risk universe that includes strategic, operational and compliance exposures beyond financial risks, and that this mindset is embedded in the company's risk culture. Encourage management to "think below the radar" and ensure that the risk profile is continually updated and presented at board meetings.

Efforts in risk management can sometimes be dispersed and unrelated to the wider organization strategy. Boards and ACs can influence management to consider integrating risk and performance management to bridge this gap. Consider incorporating key risk indicators in the same manner as key performance indicators are used in the company's balanced scorecard, to ensure that success is not achieved at the expense of risk exposures.

Most companies are also actively identifying their counterparty risks - an omnipresent risk in every contract, which is a real concern today, given the extent of the financial crisis. Counterparty risk should not deter business activities though. Rather, Boards and ACs can help to manage exposures by examining the controls in place, reviewing them on a regular basis and ensuring appropriate levels of disclosures in financial statements.

Unethical Behaviors

The increased pressure to achieve financial goals and potentially reduced investments in internal controls as part of enterprise-wide cost reduction, may inadvertently lead to a rise in risk of unethical behaviors and fraud. Boards and ACs should drive internal auditors to concentrate on areas that are predisposed to performance pressures, consider carefully the possibility of fraudulent financial reporting, and ensure there is a robust whistle-blowing program in place to enable inappropriate behaviors to be flagged out for swift attention.

Financial Reporting And Communications

Regardless of market conditions, ACs play a very important role in overseeing the accuracy, integrity and clarity of their company's financial reporting. The current economic volatility has necessitated some changes in the way ACs perform their role.

For example, many ACs are expanding their scope of oversight to include broader financial communications such as analyst calls and earnings press releases. They are also more sensitive to the language and tone in financial announcements, such as ensuring disclosures in the financial statements do not appear overly "aggressive" or "conservative" during these times, while continuing to give a true and fair view of the company's financial performance.

The market disruptions in 2008 have resulted in the impairment of goodwill and intangible assets, hitting the balance sheets of many companies. Obtaining fair values have also become more challenging. As such, Boards and ACs are spending more time to examine and evaluate the assumptions, estimates and judgments used in valuations in order to ensure that these are in line with the evolving market conditions.

Uncertainty In Going Concern

Lastly, in the preparation of financial statements by management, one of the fundamental assumptions is that the company will continue as a going concern in the next financial year. The current financial upheaval challenges this assumption, and raises substantial doubts over the accessibility and availability of funds for companies on an ongoing basis. As such, Boards and ACs need to be aware of the impact of the downturn on their companies' operating prospects and sources of funding moving ahead. It will be worthwhile for them to engage in thoughtful analyses and dialogue with management and the auditors regarding going concern assessments, so that sources of uncertainties can be addressed in a timely manner. ■