

# Director Alert

## The ABCP Liquidity Crunch – questions directors should ask

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### Introduction

Over the last several months, the global financial markets have been in turmoil as a result of the so-called ‘credit crunch’ sparked by the credit crisis in U.S. subprime mortgage loans. This situation has resulted in weakening economic growth outlooks, actions by central banks to restore liquidity and significant uncertainty as to the full economic impact of the crisis.

In Canada, contagion from the US subprime mortgage crisis led to a further complication. In mid-August, the \$35-billion non-bank asset backed commercial paper (ABCP) part of the \$120-billion Canadian commercial paper market was put into suspended animation when an initiative (the Montreal Proposal) was launched to restructure this ABCP in order to salvage investors’ holdings. This process is not yet complete, and the standstill agreement has been extended until December 2007, creating liquidity challenges for companies holding this paper – the Canadian liquidity crunch.

The governance implications for directors are both complicated and significant, and have an additional level of urgency due to quarterly and year-end reporting requirements for issuers.

Responding to the ABCP liquidity crunch is first and foremost a management responsibility. Boards and audit committees however, need, to satisfy themselves with regards to several aspects of the issue:

- that management has adequately assessed and is effectively managing the company’s exposures;
- that management has identified other financing risks to the company caused by recent market developments and is working to mitigate those risks;
- that financial statements are prepared in accordance with GAAP; and
- that clear, timely, complete and accurate disclosure has been made to shareholders in the context of required filings.

The actions that a board needs to take will depend on the issuer’s involvement in the ABCP market. For example, the implications for the board of a mining company that purchased ABCP are different from those for a director of a bank that sold commercial paper through conduits it created, or for the trustee of a non-bank sponsored special purpose entity, or for the directors of a company that routinely securitizes its receivables as part of its overall funding strategy.

It is important that directors take a broad perspective in addressing this issue. They should not just focus on the narrow questions of whether the entity held or issued ABCP and the resulting implications. Boards and management need to assess the impact that this liquidity crunch is having on the capital and debt markets, and the implications that these developments may have on the financing strategies and capital structure of the company. Boards and management of all companies, not just those directly involved in the commercial paper market, need to think about, and be prepared for, the implications if the ABCP liquidity crunch moves from “Bay Street” to “Main Street” and impacts the broader economy.

Much of the turbulence in the credit markets results from a flight to quality caused by investors who subsequently concluded that they did not have adequate information to understand and assess the risks and exposures in the ABCP they purchased. It is in the interest of everyone, and the market as a whole, that all parties provide clear, accurate and complete information – recognizing that this is a period of significant uncertainty which means estimates of fair value made at quarter and year-end will likely change in future periods.

Investors are likely to be concerned with four key issues:

1. How much commercial paper does the issuer hold?
2. How much non-bank ABCP that is subject to the Montreal proposed restructuring does the issuer hold?
3. What is the ABCP worth?
4. What are the implications for the issuer's financial condition and future prospects?

To help directors face these challenges, this paper provides some sample questions they might ask to better understand the ABCP exposures, management's response, and the accounting and disclosure obligations. No such list of questions is applicable to every situation, and directors must use their experience and judgement in determining what information they need from management and their external auditors. We hope, however, that these questions will stimulate thought and discussion and lead to more focused dialogue relating to the specific issues of each entity.

**Note: This paper does not provide any guidance or direction with respect to the measurement and disclosure requirements of Generally Accepted Accounting Principles or Canadian securities legislation or regulations. On October 29, 2007 the Accounting Standards Board (AcSB) of the CICA issued a Financial Reporting Commentary on non-bank sponsored asset-backed commercial paper. Any further guidance which may be issued by regulatory bodies regarding accounting treatment and disclosure issues relating to ABCP will be the subject of a further CICA Director Alert.**

## A. Questions relating to the extent of exposure

1. What is the process management used to identify potential loss exposures in their investments in commercial paper? How confident are they that all exposures have been identified? Has management considered the investments that might be held in company sponsored pension plans and other employee benefit plans, trust accounts, joint ventures or other reserve funds?
2. What investments does the company have in ABCP that were issued by conduits that are part of the Montreal restructuring initiative?
3. What information does management have regarding the assets that are backing the ABCP held by the company, and any claims against these assets?
4. If the company uses securitization as a funding mechanism, has management assessed the effects of potential exposure on any retained interest in securitized assets?
5. Do any of the company's customers hold significant amounts of ABCP? Would this impact collectibility of accounts receivable?
6. Has the company entered into any transactions to protect customers or others from loss relating to current market events (e.g. loan guarantees or entering into credit derivatives)?
7. What is management's best estimate of the potential monetary impact that these exposures might have on the organization? What is the level/range of measurement uncertainty associated with these estimates?
8. What method has the organization used to estimate the fair value of the ABCP currently held? What assumptions have been used and are they reasonable? (Consider the illiquidity and risk profile of these assets and that the normal presumption of carrying value being equal to fair market value may no longer hold). Has management considered the AcSB Commentary with respect to the determination of fair value?

## B. Questions related to investing/financing strategy and capital structure

1. Does the impact on the entity of ABCP exposures and related risks suggest the company should consider amending or adjusting its investment or treasury policies / procedures, or its risk management or internal audit systems?
2. Has management looked beyond the ABCP situation and considered the broader risk exposures that could result from a contraction in credit availability (i.e. reduction in credit lines, impact on hedge funds, private equity deals, etc.)?
3. If the company uses securitization as a source of funding, what is management's assessment of the impacts? How diversified are the company's financing sources? If this source of financing is no longer available, or is now too costly, what are management's plans for alternative financings?
4. How have these developments impacted the company's other sources of financing (e.g., bank lines of credit, plans for issuing long term debt or equity) and cost of financing?
5. Could these developments and the related accounting treatments (e.g., balance sheet classification, market value adjustment) cause the company to default under existing trust deeds or covenants (e.g., write down of ABCP purchased as a temporary investment causes a default in a bank covenant)?
6. Could these developments impact the company's credit rating? What were the issues of greatest concern to the credit rating agencies in previous reviews? Are these issues impacted by current developments?
7. How have these developments affected the company's liquidity and its ability to pay liabilities as they become due? How have these developments impacted the company's ability to generate and fund new business?
8. Has management considered the impact of potentially higher interest rates, tougher credit restrictions, and greater market volatility on the ongoing business?
9. What are the potential contingency planning scenarios with respect to the impact of this liquidity crisis on the company (i.e. optimistic, pessimistic, middle of the road)? What are management's response plans for each of these scenarios?
10. How will the current situation impact the company's strategic plan and operational plans? What impact will these developments have on the company's competitors? Could the competitive dynamics in the industry change?
11. Has management considered the potential opportunities created as a result of the uncertainty in the market (e.g., M&A opportunities)?

## C. Questions regarding accounting, financial reporting and disclosure

1. How does management propose to classify purchased ABCP on the balance sheet and in the statement of cash flows? Has management considered the AcSB Commentary with respect to classification of ABCP?
2. Is the nature of the ABCP and potential risk/exposure fairly stated in the financial statements and MD&A?
3. How has management determined the fair value of the ABCP held as of the balance sheet date? Has management considered the AcSB Commentary with respect to the determination of fair value?
4. Does the liquidity section of the MD&A fairly state the impact of current market conditions on the financial condition of the company and its future prospects?
5. Are the external auditors satisfied that the accounting treatment in the financial statements is appropriate and that the disclosures in both the financial statements and MD&A are fairly presented?
6. Do any of these developments suggest weaknesses in the design of internal control over financial reporting (e.g., inadequate accounting/treasury policies, over reliance on credit rating agencies, inadequate information on purchased ABCP, lack of capabilities)?
7. How has management addressed these issues in their CEO/CFO certification process? Are they satisfied that the financial disclosures in the financial statements and MD&A fairly present the results of operations and financial condition of the company?
8. Are the disclosures clear and transparent enough to enable all readers to understand the level of uncertainty and evaluate the impact of these developments on the company's results and financial condition?
9. What are management's plans with respect to investor, banker and shareholder communications, relationship management and possible reputational issues during this period of uncertainty?

## Conclusion

With regards to ABCP related risk strategy and governance, there is no "one-size fits all" solution. The appropriate business, financial and accounting/disclosure response must be based on each issuer's specific exposures and circumstances.

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