FOLEY & LARDNER LLP

Audit Committee Evolving Trends

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On February 11, 2009, Foley & Lardner LLP presented "Audit Committee Evolving Trends" as part of its National Directors Institute — Web Conference Series. The panel was moderated by Foley Partners Arthur H. (Art) Bill and Mark T. Plichta, and included panelists Richard Herlin of Deloitte & Touche LLP, Isaac Kaufman of Advanced Medical Management, and Cheryl Mayberry McKissack of Nia Enterprises, LLC. The panel discussed (1) the impact of and lessons learned from the current financial crisis; (2) the potential adoption of International Financial Reporting Standards (IFRS) by U.S. companies, including the SEC's proposed roadmap to adoption; and (3) the SEC's initiative to require financial statements to be filed using interactive data, also known as extensible business reporting language (XBRL).

The Current Financial Crisis

In light of the recent economic turmoil, it is now more important than ever that an audit committee member understand the risks and challenges facing the company. Because many companies are now subject to risks that have not existed in the past, an audit committee member must think outside of the box to identify and proactively address these emerging risks.

Three risks that audit committee members should evaluate are: (1) liquidity and counterparty risk; (2) risks related to the company's internal controls over financial reporting; and (3) disclosure and reporting risk.

Liquidity and Counterparty Risk

In light of the current economic downturn and constraints on borrowing, companies must manage their liquidity more carefully than ever. An audit committee member must understand how the company's liquidity is being managed, whether or not the company's business partners are solvent, and how liquidity issues affect the company's financial statements and contractual arrangements. Audit committee members should ask and discuss the following questions to understand the liquidity risk facing the company:

- Does the company expect to face liquidity issues in the coming year? If so, what is the company's plan to address the liquidity issues, and how will this affect the company's financial statement accounts?
- Is the company in compliance with its debt covenants? How much breathing room does it have, and what happens if the company defaults?
- Do the company's contractual partners have the liquidity to meet their obligations? If not, how does this affect financial statement accounts?
- Are there going concern issues?

Internal Control Risks

Budget and personnel cutbacks may lead companies to cut back on their internal audit functions. Because of the heightened risk of manipulation and improper reporting during economically challenging times, audit committee members must make sure their company's internal control structure is functioning properly. Audit committee members should consider:

- Has the company changed the scope of its annual assessment of internal controls over financial reporting due to budget or personnel constrains? If so, is the current structure likely to be effective? Does it need to be reexamined?
- Has the company received any correspondence from regulators, internal or external auditors, or "whistleblower" lines raising concerns about the company's internal controls in comment letters? If so, have these concerns been adequately addressed?

Disclosure and Reporting Risk
Companies should reassess the approach to, and the content of, disclosure in their financial statements. Companies' critical assumptions and disclosures are likely to have been impacted by the economic downturn. Two particular areas that audit committee members should focus on are (i) the new accounting standards dealing with fair value measurement and (ii) impairment assessments and determinations.

Fair Value Accounting FAS 157
Statement on Financial Accounting Standards No. 157 (FAS 157) has been the source of much controversy. This standard requires companies to measure the fair value of their financial instruments based on a "fair value hierarchy." The fair value hierarchy prioritizes the valuation techniques (or inputs) that should be used to value assets into three categories: Level I, Level II, and Level III. Level I inputs are defined as quoted prices in active markets for identical securities. Level II inputs are other than quoted prices for identical securities, but for which there are observable inputs (e.g., quoted prices for similar securities, quoted prices for identical securities in inactive markets, and other market-related inputs). Level III inputs are those inputs that require the use of unobservable inputs (i.e., models are used to value the assets).

An audit committee member should understand how the company is valuing its assets and that the related disclosures are appropriate and complete. Audit committee members also can better understand the company's risk profile if they have an understanding of the types of assets owned by the company (e.g., what portion of the company's assets comprises Level II or III assets). That is, if a large portion of a company's assets is based on Level II or Level III inputs (and mainly Level III inputs), the company is more likely to incur future write-downs of those assets because such inputs are generally less reliable indicators of value.

Impairment
Many companies now have market capitalizations that are lower than their book value. This likely means that the company should be considering impairment-related issues. Audit committee members should (1) understand which financial statement items should be evaluated for impairment; (2) understand how the company is evaluating these items for impairment; and (3) determine whether the company's assessment is appropriate.

In general, the impairment analysis will focus on held-to maturity securities, intangible assets (including goodwill), and deferred tax assets. A company must record unrealized losses on its held-to maturity securities if the decline in value is "other than temporary"; on its intangible assets when those assets are no longer as valuable as the amount recorded on the balance sheet; and on its deferred tax assets when they are no longer likely to be realizable — that is, the company does not expect net income sufficient to utilize the deferred tax asset.

IFRS

On August 28, 2008, the SEC announced a proposed roadmap (Roadmap) for transitioning U.S. issuers to IFRS. On November 14, 2008, the SEC released additional details relating to the Roadmap. Most recently, the SEC extended the deadline for comments from February 19, 2009 to April 20, 2009.

Under the current version of the Roadmap, early adoption may begin as early as year-end 2009. In 2011, the SEC would determine whether adoption is in the public interest and beneficial to investors. The Roadmap sets forth several milestones that, if achieved, could lead to the required use of IFRS by U.S. issuers in 2014. These milestones relate to:

- Improvements in accounting standards
- The accountability and funding of the International Accounting Standards Committee Foundation
- The improvement in the ability to use interactive data for IFRS reporting
- Education and training relating to IFRS
- Limited early use of IFRS where this would enhance comparability for U.S. investors
- The anticipated timing of future rulemaking by the SEC
- The implementation of the mandatory use of IFRS by U.S. issuers

It is unclear whether the transition to IFRS has the same support under new SEC Chairman Mary L. Schapiro and the Obama administration as it did under prior SEC Chairman Christopher Cox and the Bush administration. If the SEC decides to proceed, the transition would begin in 2014. The Roadmap contains two approaches for transition. The first would require full adoption by all public companies in 2014. The second approach would require large, accelerated filers to adopt in 2014, accelerated filers to adopt in 2015, and non-accelerated filers to adopt in 2016.

Supporters of transitioning to IFRS cite many potential benefits. First, a global set of standards would seemingly enhance comparability between companies on an international basis. Second, one set of standards would likely reduce costs for large international companies that are currently using different standards in the different countries in which they operate. Finally, many supporters of IFRS feel that its principles-based approach is superior to the rules-based approach of U.S. GAAP.

Although there are clearly benefits associated with the adoption of IFRS by U.S. issuers, the proposal also has its critics. The critics' concerns include:

- The principles-based approach that many see as a principal benefit of IFRS could lead to second-guessing of management's judgment, which could ultimately lead to increased litigation risk
- The costs of transitioning would be significant: The SEC's initial estimate is that transitioning companies could pay approximately $32 million
- The selective adoption of IFRS standards by many countries may actually lead to decreased comparability
- There is currently a lack of IFRS experience in the United States, and the transition would require a great deal of education and training

Although it is unclear if and when the transition to IFRS will occur, companies must be prepared for a potential transition. Companies should establish a multi-disciplinary team comprising members of the company's accounting, treasury, tax, information technology, and legal departments to examine the effect of the transition on the company. A few of the major items that companies should consider include the transition's effect on reporting, tax planning, financial covenants in debt agreements, and other company agreements that are tied to accounting results, such as employee benefit and executive compensation plans and agreements as well as commercial and other agreements whose terms may cause different accounting results under U.S. GAAP and IFRS.

XBRL

XBRL is the SEC's interactive data initiative that will require companies to file financial results with digital tags intended to make it easier for investors to analyze the data. The required tagging includes companies' primary financial statements, notes, and the financial statement schedules. Final rules issued by the SEC will require issuers to tag their financial data using XBRL. The new rules build on the voluntary filer program that started in 2006. The requirements will be phased in during the next three years, with the exact timing determined by the issuers' market capitalization.

The SEC touts interactive data as a means for automating regulatory filings and business information processing, with the potential to increase the speed, accuracy, and usability of financial disclosure. Audit committee members should ensure that the company has plans in place to meet the XBRL requirements, including deciding whether to handle the tagging in-house or to use an outside vendor. Audit committee members should take a proactive approach and speak to management and the independent auditors in order to gain a proper understanding of how the process will affect the company's financial disclosures.

For More Information

For more information on this session or Foley's National Directors Institute — 2009 Web Conference Series, visit Foley.com/NDI or contact the following panelists:

Arthur H. (Art) Bill
Moderator
Foley & Lardner LLP
abill@foley.com

Mark T. Plichta
Moderator
Foley & Lardner LLP
414.297.5670
mplichta@foley.com

Richard Herlin
Deloitte & Touche LLP
312.486.2942
rherlin@deloitte.com

Isaac Kaufman
Advanced Medical Management
410.790.0178
ikaufman@amm.bz

Cheryl Mayberry McKissack
Nia Enterprises, LLC
312.222.0943
cmayberry@niaenterprises.com

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