

Audit committee **alert**

January 2009

2008 year-end questions audit committee members should be asking*

Highlights

How well are the following issues being addressed in this difficult economic environment?

- Fair value measurement
- Disclosure
- Risk
- Going concern
- Documentation
- Mergers & Acquisitions
- IFRS
- Audit plan

This *alert* helps you to understand these issues and ask auditors and management meaningful questions about them.

The current economic crisis is top-of-mind for most people, and these unusual times cause audit committee members to consider what additional questions they should be asking during the 2008 reporting cycle. These inquiries coalesce around a few themes that we have structured into a series of questions that audit committee members should consider asking management and the auditors during this challenging time.

These questions are in addition to the more comprehensive series of questions that the audit committee routinely asks management and the auditors during the committee's year-end meetings. Explanations of and additional context for the questions below appear on our website: www.pwc.com/uscorporategovernance.

Fair value measurement

01. To what extent have fair value measurements impacted the financial statements?

Calendar year-end companies were required to apply a new accounting standard (FAS 157) for fair value measurements to all financial assets and liabilities as of the beginning of 2008. An elective one-year deferral was provided for most nonfinancial assets and liabilities. This new standard established a framework for measuring fair value when its use is required by generally accepted accounting principles. For companies with significant fair value measurements, audit committee members face the challenge of gaining comfort that the new requirements for measurement have been implemented appropriately. For those measures involving significant judgment, committee members should seek assurance that those judgments are being made by staff with adequate and relevant experience and are appropriately reviewed.

Fair value measurements can be derived from observable or unobservable inputs (i.e., assumptions that market participants would use in pricing an asset or liability). Observable inputs are based on market data obtained from sources independent of the reporting entity (e.g., an input based on a quoted price from a national stock exchange). Unobservable inputs reflect the reporting entity's own assumptions about the data used by market participants (buyers and sellers in the principal market) in pricing an asset or liability (e.g., inputs based on models or internally generated information).

Unobservable inputs often entail a high degree of judgment. Audit committee members should understand the level of observability and transparency underlying the fair value measurement of material classes of financial assets and liabilities in the financial statements. Committee members should focus on fair value measurements for individual assets and liabilities (or groups of assets and liabilities) that entail both a high degree of judgment by management and that are material.

02. Where fair value measures are significant, how has management demonstrated that measurement processes and controls are adequate for material amounts?

Audit committee members need to be satisfied that internal controls surrounding fair value measurements are adequate, especially for transactions involving unobservable inputs. This is especially true for classes of transactions that involve a high level of volume. Since audit committee members cannot take the time to review the fair value measurement of thousands of transactions, audit committee members must understand the internal controls on which management relies to measure fair value properly.

► *Click here for additional context*

Other accounting matters

03. How has management dealt with accounting issues that may have become more prominent because of the current economic environment?

- **Other-than-temporary impairments**—Benchmarks that some companies have relied on to determine whether an asset is impaired (e.g., percentage declines or benchmarks that are time-based) may no longer be appropriate.

➤ *Click here for additional context*

- **Tax valuation allowances**—Significant current period losses and diminished future prospects are strong negative factors in assessing the realizability of a deferred tax asset.

➤ *Click here for additional context*

- **Goodwill impairment**—Goodwill impairment may be indicated if the market capitalization of the company is (1) below book value or (2) significantly less than the sum of the reporting units' values.

➤ *Click here for additional context*

- **Taxes on foreign earnings**—Plans for repatriation of foreign cash may nullify the company's permanent reinvestment assertion and result in the recognition of taxes.

➤ *Click here for additional context*

- **Counterparty credit risk**—Need to assess the viability of counterparties and continuing effectiveness of hedges.

➤ *Click here for additional context*

- **Pensions**—The assumed discount rate and the rate of return may require revision, and the impact of potential future increases of pension cost and funding requirements may need consideration.

➤ *Click here for additional context*

These are accounting areas that are particularly sensitive in these challenging economic times. Special attention should be focused in these areas during this year-end reporting cycle.

Disclosure

- 04. Should a broad reassessment of the company's approach to the amount of disclosure and degree of transparency be made in light of (1) the current economic situation (e.g., liquidity disclosures in MD&A), (2) new concerns regarding existing disclosures (e.g., "early warning" about a potential future impairment and expanded risks and uncertainties disclosure in the financial statements), and (3) new disclosure requirements for year-end (e.g., fair value measurement and variable interest entities)?**
- 05. Are the operating segments that the company intends to present in the financial statements appropriate in light of downsizing and restructuring activities? Is the segment presentation consistent with reporting-unit information that the CEO receives and uses to run the business and that the board is given for their information?**
- 06. How does what the board is being told about liquidity, the impact of the recession and critical assumptions and judgments compare with the company's disclosures on those topics in the financial statements and MD&A?**

Given the current recession, it is more important than ever for companies to be transparent in their disclosures. Audit committees and the board should consider whether the financial statements and related disclosures tell the whole story. Disclosures should reflect the potential impact of the current economic environment on the company, including, among other things, future operations, liquidity, impairments, and key judgments/assumptions.

As a company undergoes changes, the audit committee should also monitor the reporting of operating segments to ensure the segments the company defines as such for management purposes match the segments the company reports in its financial statements. The structuring of segments could impact the evaluation of goodwill impairment, since that evaluation is performed for the company's reporting units, which may be a subset of the company's operating segments.

► *Click here for additional context*

Risk

07. What are the key risks, including non-financial reporting related risks, that the external and internal auditors have identified during their work? How were those risks mitigated?

A large rating agency has announced that a company's risk management program is one of the factors that the agency will be assessing in its rating analysis of the company. As a consequence, a company's risk management program may now have a direct impact on the company's cost of capital. In performing its oversight responsibilities regarding risk, audit committees should discuss observations that external and internal auditors have made about the company's key risks.

08. What are the underlying economic reasons for instances in which parts of the business generate returns that significantly exceed expectations?

Business units or product lines that produce returns significantly exceeding expectations could signal the need for further audit committee inquiry to understand the nature of the risk that the company has assumed. Do the returns make sense given current market conditions, which may have changed considerably since budgets were set? Is the business unit or product line taking on more risks than expected, resulting in the outsized returns? Are the company's internal auditors looking closely at the business unit or product line to ensure that necessary controls are in place?

Internal control

09. What steps has management taken to maintain the efficacy of the internal control system in light of company downsizing and cost-cutting?

Internal control is particularly important during stressful economic times, especially if the company engages in downsizing or cost-cutting. Under the requirements of the Sarbanes-Oxley Act regarding internal control, management must be satisfied that sufficient internal controls are in force, particularly during these times. Part of the audit committee's oversight should entail having a discussion with management about internal control in this environment. This discussion could include emphasis on controls over the determination of fair value; period-end financial reporting process; significant judgments and estimates; and management override of controls.

► *Click here for additional context*

Going concern

10. Is management or the auditor worried about possible going-concern issues? If so, what are the plans to focus on these issues as soon as possible? What is the anticipated impact on reporting?

The economic environment and resultant liquidity challenges may result in the need to consider the company's ability to continue as a going concern over the next year. A going concern assessment requires significant preparation and documentation, and would likely include multiple scenarios and forecasts of revenue, operating expenses, capital expenditures and debt service, as well as an analysis of the company's ability to maintain markets and other related issues. The audit committee should understand the assumptions and consider their validity in discussing the issue of going concern with management. Management's work relating to the going-concern assessment will be evaluated by the auditor. The entire assessment process can require a great deal of time and effort, so it is important for management to perform this analysis early in the reporting cycle to avoid a potential delay in the issuance of the financial statements.

Documentation

11. What is the nature of management's documentation supporting key judgments and estimates and other accounting "close calls"?

Contemporaneous documentation of key decisions is becoming increasingly vital in financial reporting. Audit committees should review with management the importance of documenting decisions. Boards and audit committees have an obligation to act in good faith, with reasonable care, and in the best interest of the corporation and its shareholders. Proper documentation is key to proving that the board acted on these obligations, even if hindsight later reveals that some decisions by the board and management were less than optimal.

M&A

12. What effect does management think the new accounting and financial reporting standards for business combinations (effective January 1, 2009) will have on the company's future deals and on its accounting for existing deals?

The new business combination standards will impact (1) how transactions are negotiated and structured; (2) how acquisitions are reflected in the financial statements; (3) how management communicates with stakeholders; (4) how companies report minority shareholder interests (now called noncontrolling interests); and (5) how companies account for transactions between controlling and noncontrolling interests. Audit committees should consider the need to understand management's assessment of the new standards, particularly if mergers and acquisitions are part of the company's current business plan.

IFRS

13. Has management considered the impact that the eventual adoption of IFRS will have on the company's current business decisions (e.g., the decision to implement a new ERP system that is not IFRS-compliant)?

Although mandatory adoption of IFRS may be years away, it is important that decisions having a long-term effect on the company's financial accounting and reporting organization (e.g., the decision to purchase a new accounting system) be made with an eye toward the potential impact of the likely adoption of IFRS by US companies. If the SEC adopts its currently envisioned timeline for US transition to IFRS, the largest public companies will be required to begin adopting IFRS in 2014. Because adoption will entail reporting three years of IFRS-compliant financial information, those companies may have to start their adoption efforts well in advance of January 2012.

Audit plan

14. What changes did the external auditors make to their audit plan in light of the current credit and economic environment?

15. How does this year's audit plan deal with the issues addressed in the recently released PCAOB Staff Practice Alert No. 3, *Audit Considerations in the Current Economic Environment*, which contains information on important year-end considerations for auditors?

Many audit teams plan calendar-year-end audits and tentatively determine materiality thresholds several months before the year-end date. Given the volatility of markets and the depth of the economic crisis in the fourth quarter of 2008, audit teams may find it necessary to revise their audit plans to emphasize additional audit areas, or to recognize changes in materiality thresholds. More specifically, audit plans may be impacted in audit areas such as: (1) liquidity considerations, (2) going-concern evaluations, (3) fair value measurements, (4) third-party pricing data, (5) other-than-temporary impairment, (6) impairments of goodwill and long-lived assets, (7) revenue recognition, (8) risk of fraud, (9) management override, and (10) considerations regarding internal control over fair value measurements.

► *Click here for additional context*

Fair value measurement (additional context)

The standard defines three levels of inputs that companies should consider when determining fair value:

Level 1—Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. The fair value hierarchy gives highest priority to these inputs.

Level 2—Inputs other than quoted prices within Level 1 that are observable for the asset or liability either directly or indirectly.

Level 3—Unobservable inputs for the asset or liability; used when observable inputs are not available such as when there is little, if any, market activity at the measurement date.

Distressed markets and distressed/forced transactions could also complicate a valuation. In evaluating market activity for purposes of determining fair value, a company may ignore a distressed or forced transaction, but it cannot ignore a distressed market. For example, if the sole market for a particular security comprises hedge funds looking for distressed sellers, then that fact pattern could define the market and would therefore need to be considered.

Other accounting matters (additional context)

Other-than-temporary impairment (OTTI)

All investments in debt securities and investments in equity securities that have a readily determinable fair value are accounted for based on management's intention as to the ultimate disposition of the security: hold-to-maturity (debt securities only), trading or available-for-sale.

Hold-to-maturity debt securities are recorded at amortized cost. Trading and available-for-sale securities are recorded at fair value, but only the unrealized gains or losses on trading securities routinely impact the income statement. Unrealized gains or losses from available-for-sale securities are recorded in shareholders' equity, through other comprehensive income.

This changes, however, if the decline in the fair value of hold-to-maturity and available-for-sale securities is considered other-than-temporary. If a decline is considered other-than-temporary, the amount of that decline (the impairment) is recorded as a charge to the income statement. Some companies have used predetermined parameters as a guide to determine whether declines in the fair values of their securities are other than temporary. For example, some companies believe a decline may be other-than-temporary if it lasts for a certain number of months. However, the appropriateness of a rule-of-thumb of that nature needs to be evaluated in light of current market conditions.

Other factors, such as the financial position and near-term prospects of the company issuing the security and the continuing intent and ability to hold an investment until the market recovers, require close scrutiny. Audit committee members should understand how management has incorporated into the OTTI consideration factors such as recent market turmoil and changing liquidity needs. Committee members should inquire as to the nature of management's documentation supporting the conclusions resulting from its consideration of those additional factors.

Tax valuation allowances

Deferred tax assets (DTAs) represent an asset that will be realized primarily by loss carrybacks, future taxable income, or reversal of existing taxable temporary differences in the future. A valuation allowance is recorded against a company's DTAs if it is "more likely than not" that the DTAs will not be realized in the future.

The evaluation of the realizability of DTAs is subjective and based on the weight of available evidence regarding whether the "more likely than not" criterion has been fulfilled. In practice, companies often use a guideline, such as a cumulative three-year loss test (i.e., if results of operations add up to a cumulative loss for the last three years, a valuation allowance is established).

Audit Committee members should make sure that a guideline, such as the three-year cumulative loss test, is not used as a hard-and-fast rule for establishment of a valuation allowance. This is especially important when current market conditions may have increasingly impaired the company's ability to become profitable, or when a company experiences significant current period losses. Also, make sure that the realizability of DTAs is determined by the company on a tax jurisdiction-by-jurisdiction basis.

Goodwill impairment

The market capitalizations of many companies have recently declined. Such declines could have implications on the goodwill impairment test that many companies perform at year-end or whether an interim test is required.

The goodwill test is performed at the reporting unit level, which may be at the operating segment level or one level below. The test has two steps, with the second step being required if the fair value of the reporting unit is less than its book value. Since most companies have multiple reporting units and these units are not publicly traded, the determination of the fair value of the individual reporting units requires the use of valuation techniques, such as a discounted cash flow approach.

These valuation exercises often require the use of internally and externally available information, and may also involve future projections of revenue, cost, and the cost of capital. The audit committee should be aware of the assumptions management is using.

There is one other, less obvious area about which the audit committee should have an understanding: situations where management decides not to record an impairment loss, even though the company's market value is significantly less than the total value of its reporting units. After completing the first step of the goodwill impairment test, management commonly conducts a reasonableness test to compare the sum of the fair values of the reporting units with the company's market value. If that market value is less than the total value of the reporting units, audit committee members should understand the underlying reasons for that difference and why an impairment charge is not required.

Taxes on foreign earnings

Many companies have asserted that unremitted earnings are indefinitely reinvested in one or more foreign jurisdictions. This assertion of indefinite reinvestment outside of the US results in a company not recognizing a tax liability on those earnings. Audit committee members should consider whether this assertion is still reasonable in light of the impact of current economic conditions on the company's liquidity and potential need to repatriate taxable earnings from abroad.

Counterparty credit risk

The impact of the current credit environment on certain counterparties to derivative transactions, credit arrangements and insurance obligations has been well documented. Management scrutiny of the impact of the current credit environment on a more broadly defined class of counterparties should be of interest to audit committee members as well. This broader class of counterparties may include significant customers, suppliers, and joint-venture partners. One director recently described his view of such scrutiny as a 360-degree review of entities on the other side of all significant transactions and relationships with the director's company.

Pensions

The calculation of pension obligations and expense is based on several assumptions, including an assumed discount rate on the benefit obligation, an expected rate of return on plan assets, and a projection of salary increases for benefits based on future salaries. Audit committees should be accustomed to evaluating these key assumptions certain of which are long-term assumptions and therefore may not have changed for most companies from year to year. That may need to change depending on the particular circumstances surrounding the plan.

For example, steep market declines may cause the actual asset mix in the plan's investment portfolio to vary considerably from the company's targeted asset mix. If the company does not intend to rebalance its investment portfolio, it should adjust the expected rate of return for 2009 to reflect the actual asset plan mix. In addition, the interest rates inherent in high-quality corporate bonds used to establish the discount rate assumption should also be revisited given market events in 2008.

This is an area where transparent disclosure will be important, particularly relative to increased cash obligations that a company may have as a result of the decline in the value of plan assets.

Disclosure (additional context)

Audit committee members provide an independent perspective on the quality and appropriateness of the company's disclosures. Recent market conditions have led investors and other users of financial statements to pay attention to companies' disclosures about liquidity, market risks, and, in certain instances, going-concern issues.

Liquidity disclosures should include robust and transparent discussions of current and anticipated uncertainties about commitments and demands, which SEC literature defines as being "reasonably likely" to result in a material change (e.g., the impact on liquidity of a downgrade in the company's credit rating).

Disclosures regarding market risk should explain how the company manages interest rate risk, foreign-currency-exchange risk, commodity price risk, and equity price risk. If a company expects significant liquidity issues within the upcoming year, robust disclosure about the liquidity issues and resultant impact on the company's ability to continue as a going concern should be considered. For all disclosures being considered, audit committees should consider the effectiveness of those disclosures to provide an "early warning" of future events.

Internal control (additional context)

Given the added disclosure considerations described above and the volatile risk environment for most companies, it is more important than ever that there be a proper tone at the top, coupled with high-quality, entity-level controls and effective risk management policies and procedures. Most boards and audit committees are sharply focused on risk management in light of recent events, but continued emphasis on the appropriateness and operation of key controls would seem to be in order.

Audit plan (additional context)

The Public Company Accounting Oversight Board (PCAOB) oversees the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports. The purpose of PCAOB Practice Alert No. 3, *Audit Considerations in the Current Economic Environment* (issued December 5, 2008), is to help auditors identify which matters relating to the current economic environment might affect audit risk and require additional focus. Such matters include the following:

- Auditing fair value measurements
- Auditing accounting estimates
- Auditing the adequacy of disclosures
- Auditor's consideration of a company's ability to continue as a going concern
- Additional audit considerations for selected financial reporting areas, including: consolidation; contingencies and guarantees; debt obligations; deferred tax assets; derivatives; goodwill; intangible assets and other long-lived assets; inventory; other-than-temporary impairment; pensions and other postretirement benefits; and receivables

How PwC can help

To have a deeper discussion about how these subjects might affect your business, please contact:

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