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2009 year-end questions audit committee members should be asking

Highlights

How well are your companies addressing the following issues in this environment of active regulatory reform and moderate economic recovery?

Year-end reporting issues

- Accounting matters
- Disclosure
- Internal control
- Risk management

Other considerations

- Consolidation accounting
- Antitrust and anticorruption compliance
- Tax reform
- IFRS
- Ongoing standard-setting, regulatory, and legislative initiatives

This report will help you to understand these issues and ask management and your auditors meaningful questions about them.

Audit committees will need to consider the implications of the current regulatory reform activities and the moderate recovery of the economy on a company's year-end financial reporting. This document provides audit committees with a series of questions that may have particular importance for year-end, and may be helpful as you prepare for discussions with management and the auditors. These questions should be considered with other questions the audit committee routinely asks management and the auditors at year-end.

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Year-end reporting issues

Accounting matters

01. How has management dealt with accounting issues caused by continuing economic challenges?

- **Impairments**—Decreases in the fair values of inventories, receivables, investments, long-lived assets, or goodwill may indicate the need to recognize an impairment charge.
- **Tax valuation allowances**—Cumulative losses, current period deficits, and diminished prospects for sufficient future taxable income, notwithstanding profitability improvements that companies may be experiencing currently, are strong negative factors that will need to be considered when assessing the realizability of deferred tax assets.
- **Pensions**—Depressed plan asset values may require employers to make or increase their contributions to the plan. The effects of changes in assumed discount rates could increase pension expense for 2010. Pension expense may also increase if a company determines that its expected long-term rate of return on plan assets assumption requires adjustment.

02. How is management ensuring the timely and adequate documentation of the key judgments it has made regarding accounting estimates and complex accounting determinations?

In the current environment of heightened regulatory scrutiny, contemporaneous documentation of key decisions is increasingly important. Audit committees should review with management the importance of documenting key judgments regarding accounting estimates and complex accounting determinations in a manner that will enable the audit committee to review the reasonableness of those judgments. Elements that are critical to a framework for reviewing the reasonableness of management's judgments generally should be reflected in the documentation and include (1) evaluating alternative accounting treatments, (2) considering all available evidence, (3) documenting the thought process applied at the time estimates are made, and (4) transparency in disclosures about judgments. Management's proper and timely documentation of key decisions, demonstrating that a thoughtful assessment was performed, can help to enhance audit committee members' understanding of key accounting decisions reflected in the financial statements and also can serve as very useful support for those who review such decisions (e.g., auditors and regulators).

Disclosure

03. How is management addressing SEC calls for transparency and improved disclosures about the ongoing effect of the economic environment on the company, in particular its impact on operations and business risks (e.g., restructuring activities, liquidity disclosures, customer and supply chain risks), and the need to consider foreshadowing disclosures (e.g., "early warning" about potential future impairments)?

04. Are the operating segments that the company intends to present in the financial statements still appropriate in light of any restructuring activities or purchases and sales of business units? Is the segment presentation consistent with the level of detailed information that the Chief Operating Decision Maker (CODM), commonly the CEO, receives and uses to run the business?

05. Are discussions by the board about critical risks, assumptions, and judgments consistent with the company's disclosures on those topics in the financial statements and Management's Discussion & Analysis (MD&A)?

Given the current regulatory environment and post-recession state of the economy, it is more important than ever for companies to be transparent in their disclosures. Audit committees should consider whether the company's financial statements and related disclosures are sufficiently transparent, reflecting the potential impact of the current economic environment on the company, including future operations, liquidity, impairments, and key judgments and assumptions, among other items.

As a company undergoes operational and structural changes, the audit committee also should monitor whether the company's prior reporting of its operating segments is still appropriate in light of these changes. In addition to ensuring accurate segment disclosures, the appropriate identification of operating segments is a critical first step to evaluating goodwill for impairment.

Internal control

06. How has the company's internal control system been impacted by cost-cutting and lay-off programs?

Cost cutting and lay-offs may place added stress on a company's system of internal control. Under the requirements of the Sarbanes-Oxley Act, management is responsible for designing and maintaining effective disclosure controls and procedures and internal control over financial reporting. Additionally, management must assess annually the effectiveness of the company's internal control over financial reporting and report any significant changes to it. Part of the audit committee's oversight should entail having a discussion with management about the company's internal control, specifically addressing significant changes to internal control resulting from recent changes in company structure or staffing.

Risk management

07. How will the company articulate the audit committee's and board's role in overseeing the key risks facing the company?

A new SEC rule requires a number of new proxy disclosures for the 2010 proxy season. One of these items is a discussion about the board's role in risk oversight. That disclosure might include a discussion about which board committees are involved in that activity in addition to the full board. The disclosure may also address the relationship between the board and management in managing the material risks facing the company, and whether the individuals who supervise the day-to-day risk management responsibilities report directly to the board or a board committee, among other things.

08. How is management assessing whether compensation policies and practices may create incentives that promote inappropriate risk-taking? How is the company preparing to comply with the new SEC proxy disclosure requirement regarding compensation, risk, and rewards?

Audit committees may need to engage in greater dialogue with compensation committees as companies prepare new SEC-required proxy disclosures related to compensation and risk, starting with the 2010 proxy season. One of the new required disclosures is about the company's compensation policies and practices for all employees, not just executive officers, if the policies create risks that are reasonably likely to have a material adverse effect on the company. In addition, the disclosure requirements for stock and option awards to company executives and directors now call for disclosure at aggregate grant date fair value, among other things.

A review of compensation and risk requires an understanding of major risk areas, employees or employee groups who can influence these risks, and the compensation programs and policies that cover these employees. These reviews may require audit committees, often tasked with reviewing management's policies for assessing and managing risk, and compensation committees, tasked with reviewing compensation structures, to collaborate to understand management's assessment. Audit committees will also want to understand what risk-adjusted performance metrics are being used for compensation purposes.

Other considerations

Consolidation accounting

09. What is management's evaluation of how the new consolidation guidance for variable-interest entities will impact the company's financial statements and related debt covenants, financial ratios, compensation arrangements, and internal control report?

Calendar year-end companies (with a few exceptions) will apply new consolidation guidance for variable-interest entities (where the controlling interest is not based on majority voting rights) beginning January 1, 2010, which could lead to companies including more of these entities in their financial statements. Management will also have to cover these entities in its assessment of internal controls. Audit committees will need to discuss with management the financial statement impact of newly consolidated or deconsolidated entities and understand management's plans to address the related impact on debt covenants, financial ratios, systems, processes, and internal controls.

Antitrust and anticorruption compliance

10. How is management ensuring that the company complies with antitrust and anticorruption laws, considering the significant focus regulators and authorities are placing on this area?

Enforcement of antitrust and anticorruption laws has increased, and enforcement agencies from various countries are coordinating their investigative efforts. Audit committees should discuss with management the company's standards and policies, how risk is assessed in this area, and the effectiveness of compliance programs to understand whether there are any year-end implications. Factors to consider may include the nature and geographic spread of operations, the current economic environment in which the company operates, and changes in the company's structure, among other items.

Tax reform

11. How is management monitoring tax reform? What might be the effects of significant anticipated changes in the taxation of income earned by foreign subsidiaries?

Possible tax reform proposals being suggested today could impact a US company's strategy and ability to defer US tax on unrepatriated foreign earnings, by deferring certain US based deductions until the earnings are repatriated and diluting the credit for foreign taxes paid. Audit committees should discuss with management the potential effects of possible tax proposals on the company's tax rate, competitiveness, and financial performance. They may also discuss with management whether any changes will be needed to the company's assertions regarding permanent reinvestment of earnings in international jurisdictions and understand the related accounting implications.

IFRS

12. Has management executed oversight of non-US subsidiaries that are adopting IFRS that is sufficient to ensure effective and efficient adoption, and consistency in approach throughout the company?

One of the primary IFRS drivers affecting US companies today is the continued global adoption of IFRS for local and statutory reporting. The July 2009 release of IFRS for Small and Medium-sized Entities (IFRS for SMEs) by the International Accounting Standards Board will likely accelerate IFRS adoption for statutory purposes and, thus, the need for US companies to assess the near-term impact of IFRS on their businesses. For example, the UK is proposing to replace most of existing UK GAAP with full IFRS or IFRS for SMEs by 2012. Audit committees should discuss with management its process to monitor statutory IFRS adoption requirements globally and its oversight of affiliates as they prepare to adopt IFRS for statutory reporting. Areas to consider are adoption of consistent accounting policies among subsidiaries and alignment of those policies with policies expected to be elected by the parent, timing of adoption, worldwide tax and information systems implications, and impact on people and processes.

Ongoing standard setting, regulatory, and legislative initiatives

13. What does management believe will be the impact of relevant regulatory activity on the company? What actions does the company need to take to prepare for the potential enactment of the new rules and laws?

There are ongoing initiatives that may have broad impact on a company, including its financial reporting. The FASB is deliberating a number of broad topics including financial statement presentation, revenue recognition, financial instruments, and leasing, among others. Exposure drafts on these projects are expected in 2010, with final releases expected by 2011. A new standard for loss contingencies may be effective in 2010. For its part, the SEC has begun to refocus attention on International Financial Reporting Standards (IFRS), and there may be developments in that area.

Legislators have proposed reforms to the financial system and to regulate derivatives. They also have proposed reforms to health care and environmental rules that could have a significant impact on certain companies. Audit committees, directors, and management will need to monitor these developments, discuss the iimpact these changes could have on the company, and prepare for the potential enactment of new rules and laws.

How PwC can help

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

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