Audit Committee Brief

SEC Focus Areas

Recent economic events have heavily influenced the SEC's scrutiny of financial reporting. At the 2009 AICPA National Conference on Current SEC and PCAOB Developments, SEC Director of Enforcement Robert S. Khuzami said that during fraud investigations, his division is evaluating whether boards of directors and audit committees have properly discharged their duties. This evaluation includes determining whether red flags and other information that may have identified fraud were recklessly ignored.

Mr. Khuzami said that enforcement personnel are focusing on whether boards and audit committees are active in accounting and audit issues and have set the appropriate tone regarding misconduct and the need to produce accurate financial statements. This involves assessing whether directors and audit committee members have delved into key accounting issues, understood the registrant's financial reporting, and required thorough answers to their requests for information.

Given these considerations, together with the SEC's focus on enhancing disclosures for the benefit of investors, audit committees may wish to engage in the financial reporting process at an earlier point, with particular attention to key areas for which the staff continues to request more transparent reporting and disclosure. This edition of the *Audit Committee Brief* provides insight on recent SEC comments on registrants' filings, as well as the new guidance on non-GAAP and climate change disclosures.

Comment Letters and Recent Public Remarks by the SEC Staff

Christine Q. Davine, national director of SEC services, Deloitte & Touche LLP, said, "The SEC staff reviews the filings of each issuer at least once every three years, and more frequently in certain circumstances. The SEC staff's comment letters often ask questions about complex transactions and difficult financial reporting topics, and suggest improvements that companies can make to their disclosures. It is important that audit committees be aware of the comments their companies have received and the company's responses to determine whether the issues that the SEC staff has identified warrant increased audit committee focus."

The SEC staff's comments and registrants' responses for all companies are posted on the SEC's Web site and provide valuable insight into common themes. Members of management may incorporate a review of the comments, as well as recent public remarks by the SEC staff, into the financial reporting process to help improve the company's financial statements and disclosures. Audit committees may discuss the results of the review with management. Our *SEC Comment Letters on Domestic Registrants* publication can assist in this process.

Audit committee members should be aware of the following recent topics and trends in SEC comment letters and public remarks by SEC staff members:

- Management discussion and analysis (MD&A)
- Goodwill impairment testing
- Deferred tax valuation allowances and the repatriation of foreign earnings
- Fair value
- Debt
- Other-than-temporary impairments (OTTI) of investment securities
- Pensions
- Executive compensation

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Christine Q. Davine, national director of SEC services, Deloitte & Touche LLP

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MD&A: The SEC staff expects MD&A disclosures to provide clear, meaningful information to investors, and to address how the economic environment is affecting operations, liquidity and capital resources, and critical accounting policies. An important area of concentration is the critical accounting policies section, which focuses on those items in the financial statements that require significant management estimates and judgment.

Additional considerations for audit committees:

- Does the MD&A provide investors with the reasons behind material fluctuations in financial results?
- Does the MD&A adequately address known trends and uncertainties that are reasonably likely to materially affect the registrant (e.g., recent reductions in key customer or vendor performance or liquidity, a registrant's potential need for additional financing, etc.)?
- Does the critical accounting policies section include all areas that require significant management estimates and judgment that are material to the registrant?

Goodwill impairment testing: The SEC staff has been asking registrants for more disclosure on the conditions that resulted in impairments and what those conditions mean to the registrant's business. The staff is also requesting additional, robust disclosure about events or circumstances that could result in future impairments.

Additional considerations for audit committees:

- Understand management's monitoring process for events triggering impairment testing.
- Periodically review with management the extent to which the fair value of the company's reporting units with material goodwill assigned exceeds their carrying value.
- Discuss with management the reasons behind any goodwill impairments and consider whether the financial statements include adequate disclosure. For example, were impairments driven by a decrease in cash flow due to a reduction in revenues? If so, have planned cost reductions or additional financing needs been disclosed?

Deferred tax valuation allowances and the repatriation of foreign earnings: The SEC staff has provided frequent comments on the registrant's assessment of the realizability of deferred tax assets and the tax accounting consequences of repatriating foreign earnings. In the critical accounting estimates section of MD&A, registrants should consider disclosing:

- A discussion of the effects that the economic environment is having on the realization assessments of deferred tax asset balances
- Any triggering events or new evidence leading to an adjustment of the valuation allowance, and the effects on current and future results.

When preparing disclosures about the repatriation of foreign earnings, registrants should consider disclosing the current and anticipated effects of repatriation on the entity.

The IRS has suggested the following questions for corporate boards to ask their tax directors and external auditors. Given their role, it would be appropriate for audit committees to ask these questions as well:

- What was the process for identifying uncertain tax positions and how do you know all material issues have been identified?
- How did you go about determining the maximum tax exposure relating to each uncertain tax position? What makes you comfortable that it accurately reflects your maximum exposure?

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Fair value: In addition to disclosures required by the authoritative guidance ASC 820 – *Fair Value Measurements and Disclosures* (formerly SFAS 157), the SEC staff is encouraging registrants to provide transparent disclosures in the MD&A about the use of significant unobservable inputs in fair-value measurements and about fair-value measurements of material financial instruments that are not traded actively.

Additional considerations for audit committees:

- Understand the extent of the use of fair-value measurements in the company's financial statements.
- Review with management the assumptions and techniques used and the process for determining whether these measurements are appropriate.

Debt: The SEC staff is focused on confirming that disclosures of debt covenants provide investors with an understanding of events or circumstances that could result in noncompliance.

Additional considerations for audit committees:

- Periodically review with management all covenants for compliance and assess whether any disclosures are required.

Other-than-temporary impairments (OTTI) of investment securities: The SEC staff is encouraging registrants to describe how management concluded that an investment with a fair value below amortized cost is not other-than-temporarily impaired, and to discuss the factors considered in OTTI determination.

Additional considerations for audit committees:

- Assess management's process for identifying, recording, and disclosing impairments.
- Confirm that this process incorporates recent changes in accounting and disclosure.

Pensions: The SEC staff continues to comment on disclosures about significant assumptions used in calculating the pension obligation and the fair value of plan assets. These comments have focused on the effects of the current market on the selection of assumptions and disclosure of the impact of changes in significant assumptions on the company's estimates (e.g., a sensitivity analysis).

Additional considerations for audit committees:

- Review the assumptions used with management. Consider including specialists in the review.
- Consider whether assumptions contemplate current market conditions.

Executive compensation: This disclosure should focus on material principles and important factors influencing the registrant's executive compensation policies and decisions. The SEC staff prefers clear and concise disclosures with tables and graphs. For further information, please see January's *Hot Topic:* "SEC's New Rules Raise the Bar on Proxy Disclosure in 2010."

Additional considerations for audit committees:

- If the company needs to address the new executive compensation disclosure requirements in its 2010 proxy, consider asking management to provide a map of the new requirements to the related revisions in the draft proxy.

The audit committee may want to provide additional consideration to these comment areas during its review of the financial statements and discussions with management. While the SEC staff has focused recently on the above topics, there are other topics that the SEC frequently comments on (e.g., segment reporting, business combinations, revenue recognition, etc.) For more information on these and other topics, please refer to Deloitte's third edition of *SEC Comments on Domestic Registrants*.

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Key changes related to the use of non-GAAP financial measures:

- The prohibition in Item 10(e) of Regulation S-K related to adjustments made to a non-GAAP financial performance measure has been clarified. It has been noted that the prohibition is based on the description of the charge or gain rather than its nature. Registrants may make adjustments they believe are appropriate, subject to Regulation G and Item 10(e). The additional disclosure requirements that were in the former guidance have been removed.
- The meaning of "expressly permitted" has been clarified. A measure is "expressly permitted" if it is clearly and specifically identified as an acceptable measure by the standard-setter responsible for establishing the GAAP used in the company's primary financial statements included in its SEC filing.
- The guidance now clarifies that a registrant is not prohibited from "disclosing a non-GAAP financial measure that is not used by management in managing its business."
- It has been clarified that "a registrant may present an adjustment 'net of tax' when reconciling a non-GAAP performance measure to the most directly comparable GAAP measure," provided that it makes certain disclosures.

Non-GAAP Financial Measures

The SEC's Division of Corporation Finance issued new interpretive guidance on the use of non-GAAP financial measures in January 2010. This guidance provides registrants with more flexibility to disclose non-GAAP measures in SEC filings. The Compliance and Disclosure Interpretations (C&DIs) replace previously issued interpretative guidance, but the rules on the use of non-GAAP financial measures were not amended, as all non-GAAP disclosures must still be reconciled to GAAP. While registrants frequently include non-GAAP financial measures in press releases, many have been reluctant to include these same measures in filed documents because of restrictions in the rescinded interpretive guidance.

Mark Kronforst, deputy chief accountant in the SEC's Division of Corporation Finance, said that the new guidance would stress that the disclosures related to non-GAAP measures should include explanations that are clear, understandable, and specific to the registrant and its industry.

Audit committee members should be aware of the new C&DIs and work with management to establish guidelines for the use of non-GAAP measures in SEC filings. Guidelines may include the types of adjustments permitted and should be reviewed and updated periodically.

For additional information, please refer to the January 20 issue of *Heads Up*: "SEC Issues Compliance and Disclosure Interpretations on Non-GAAP Measures."

Climate Change Disclosures

The SEC issued in February 2010 its interpretive release on climate change disclosures. The interpretive guidance does not create new disclosure requirements; rather, it clarifies "certain existing disclosure rules that may require a company to disclose the impact that business or legal developments related to climate change may have on its business."

The release addresses four climate-change-related topics that registrants should consider when assessing what information to provide under existing SEC disclosure requirements:

- The impact of existing and potential litigation or regulation
- The effects on the business of international accords and treaties related to climate change and governing greenhouse gas emissions
- The actual and potential indirect consequences of climate-change-related regulations or business trends (the release includes examples of indirect consequences)
- The actual and potential impacts of the physical effects of climate change on the business

For more information, see the February 5 issue of *Heads Up:* "A Climate for Change?"

Conclusion

Audit committees are under greater scrutiny to protect the interests of shareholders, and a number of developments at the SEC and in the realm of corporate governance need to be considered. Audit committee members should be vigilant in monitoring these changes as they execute their obligations regarding financial oversight.

Additional resources

Highlights of the 2009 AICPA National Conference on Current SEC and PCAOB Developments are available in the December 17 issue of *Heads Up*.

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