

# BoardMatters Quarterly

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## Upcoming financial reporting considerations

As we enter 2010, uncertainty remains as to when the economic markets will ultimately settle. We have seen signs of a potential economic upturn as well as concerns of a continued recession. One thing is certain: companies and their audit committees must prepare for the risks that lie ahead and consider changes that may affect them in the months to come. This issue of *BoardMatters Quarterly* is dedicated to helping audit committees identify and prepare for key financial reporting considerations that their companies may face. Audit committees need to understand top agenda considerations as we approach the year-end reporting season and begin a new year.

Please feel free to contact us with your feedback on this issue of *BoardMatters Quarterly* or with your ideas for future issues. We encourage you to share this information with your colleagues and ask that you let us know of others who would benefit by receiving this publication. Send your feedback to Meaghan Levasseur at [meaghan.levasseur@ey.com](mailto:meaghan.levasseur@ey.com).



# Financial reporting considerations – looking ahead to 2010

With the effective date right around the corner, new accounting requirements for consolidation and securitizations will affect more than just financial institutions.

In June 2009, the US Financial Accounting Standards Board (FASB) issued new accounting guidance for consolidation and transfers of financial assets. Beginning in January, calendar year-end companies will be required to follow this new guidance on determining which entities should be included in consolidated financial statements and the accounting for securitizations. These new requirements will affect all industries and implementation will require more than just determining what goes on or comes off the financial statements.

The accounting guidance for consolidation addresses when a company should include the assets, liabilities and activities of another entity in its financial statements.

The accounting guidance for transfers of financial assets – including securitizations and factoring arrangements – addresses whether the transfer of financial assets constitutes a sale and the determination of any resulting gain or loss, or a secured borrowing. The FASB has been addressing the issue of accounting for transfers for several years.

One of the most significant changes to the accounting for transfers is the elimination of the Qualifying Special-Purpose Entity (QSPE) concept. QSPEs are financing vehicles very common in the securitization of mortgage loans, credit card receivables and other assets. Under the previous accounting guidance, QSPEs were passive entities that were generally not subject to consolidation by their sponsor or transferors. Because a QSPE was designed to be on “autopilot,” it was not controlled by the transferor or any other party.


As a result, some FASB constituents requested that the QSPE concept be removed from US Generally Accepted Accounting Principles (GAAP), which the FASB did in issuing FASB Statement No. 166, *Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140* (Statement 166). One effect of that change is that these structures are now subject to consolidation. In response to this change, and other criticisms of the consolidation guidance, the FASB also conducted a broader examination of the consolidation model.

The previous accounting guidance for consolidation addressed off-balance-sheet structures through the concept of Variable Interest Entities (VIEs). VIEs are entities that cannot be evaluated for consolidation based on the shareholders' relative voting interests, but instead are evaluated based on variability in potential economic returns. The party (if any) that absorbed the majority of the variability would consolidate the VIE.

Many critics of this approach believed that the determination of who consolidates a VIE can be overly complex and, by emphasizing quantitative analyses, at times required a company to consolidate an entity over which it had little or no decision-making ability. Financial statement users also expressed concern over the lack of transparency (either through non-consolidation or through lack of disclosure) of involvement with off-balance-sheet structures, thus limiting financial statement users' ability to understand both the nature of an enterprise's involvement with a VIE and the related risks and benefits of that involvement.

FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)* (Statement 167), addresses these concerns by, among other things, replacing the mathematical-based determination of who must consolidate a VIE with a qualitative analysis. This analysis considers the purpose and design of the VIE as well as the risks that the VIE was designed to create and pass through to its variable interest holders. A company will be required to consolidate a VIE if the company has both –

- ▶ The power to direct the activities of a VIE that most significantly affect the VIE's economic performance (power), and
- ▶ The obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE (benefits)



In applying the power concept, kick-out rights (i.e., a limited partner's ability to dissolve the partnership or otherwise remove the general partner without cause) generally cannot be considered in determining whether a party has power, which is a significant change to current practice. Under the previous guidance, kick-out rights held by an entity's voting interests generally prevented an entity from being a VIE. This change will lead to more consolidation.

## Industry effects

### *Financial services*

At the time of this publication, the FASB has proposed deferring the application of Statement 167 to certain investment entities such as hedge funds and private equity funds until the FASB revisits its consolidation guidance more broadly. The proposed deferral would not affect the requirement to bring many off-balance-sheet structured financing vehicles onto the books, which will significantly affect the financial statements of many financial institutions. More securitization vehicles holding residential and commercial mortgage loans, credit card receivables and automobile loans will be consolidated by sponsors and transferors resulting in the need for them to evaluate credit and collectibility risks. Additionally, more asset-backed commercial paper conduits and structured investment vehicles will be consolidated. The consolidation of these entities will affect a financial institution's balance sheet and regulatory capital.

### *Life sciences*

Research and development funding structures that had been consolidated based on the previously required quantitative assessments may need to be deconsolidated if no individual party has power. Ventures subject to joint control by the participants (that is, power is shared among multiple unrelated parties such that no one party has the power to direct the activities of the venture), generally will not be consolidated.

### *General*

Statement 166's changes will affect more than just securitizations and structured financing vehicles. Entities that sell receivables to commercial paper conduits will need to evaluate the effects of these changes on those transactions.

## Other effects

The new guidance for consolidation and transfers also will affect more than what goes on or comes off the financial statements. Entities consolidated under the new guidance will be subject to Section 404 of the Sarbanes-Oxley Act, so companies will have to evaluate the necessary changes to internal control, and their internal control assessment processes, to address those entities. Companies may also have to spend time informing their investors about the changes to the financial statements as a result of the new guidance, as well as evaluating the effects on debt covenants and regulatory capital requirements, among others.

## Financial reporting considerations

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## Questions for the audit committee to consider

- ▶ Has the company completed an inventory of on- and off-balance-sheet entities that could be affected by changes to consolidation requirements?
- ▶ If additional entities are required to be consolidated, will the company have access to necessary financial information to be able to meet financial reporting requirements?
- ▶ Has the company considered necessary changes in internal control for the new guidance – both internally and at newly-consolidated entities?
- ▶ Has the company considered how their newly-consolidated entities will be addressed in the Section 404 assessment process?
- ▶ Will changes to the consolidated financial statements affect debt covenants or regulatory capital requirements?

## Year-end considerations

As the financial reporting year comes to a close, companies should consider the new economic realities in their annual financial reporting

### Income taxes

Companies need to assess if a valuation allowance is needed for deferred tax assets given the current economic environment. Cumulative losses in recent years, and the use of tax planning strategies and projections of future taxable income, should be carefully considered in that analysis.

In general, US GAAP presumes that all foreign earnings will be remitted to the parent. Companies can overcome that presumption with evidence of specific plans of indefinite reinvestment in the foreign operations. Declining market conditions and cash needs of the parent company may call into question a company's ability to continue to reinvest foreign earnings indefinitely.

- ▶ What are the most significant judgments used in management's analysis of deferred taxes? Do they remain reasonable?

### Goodwill and other intangible asset impairment

The continuing effects of the economic slowdown may indicate that goodwill or other intangible assets may be impaired. Companies are required to evaluate goodwill annually or when impairment indicators are present. Additional interim impairment tests may be needed given the current economic environment. Additionally, the SEC staff has focused on how a company considers its market capitalization in its impairment analyses.

- ▶ What process and key assumptions did management use in developing its estimates of fair value?

### Impairment of debt securities

In 2009, the FASB amended the guidance for measuring, recognizing and presenting the impairment of debt securities in the financial statements. Among other changes, this new guidance requires an impairment to be recognized before it is "probable" an amount will be uncollectible.

- ▶ What methods does the company use to review its portfolio of debt securities for other-than-temporary impairment?
- ▶ How does management regularly update its estimates of future cash flows?

### Fair value

The FASB clarified certain aspects of its fair value measurement guidance in 2009, including determining fair value when market activity has declined, the measurement of liabilities and the valuation of various alternative investments, and adding disclosure requirements.

- ▶ How has the new fair value guidance affected the company?
- ▶ Has the company changed its processes for determining fair value?

# Fraud risks facing audit committees

In an effort to deal with financial pressures, many companies have reduced headcount and infrastructure costs. These reductions can weaken internal controls and create the perfect opportunity for fraud to occur.

Common schemes employed for financial reporting fraud include improper accounting for significant or unusual transactions; manipulation of management estimates of fair value relating to real estate assets and financial instruments; management of reserves; and improper revenue recognition as a result of undisclosed side letter agreements and bill and hold arrangements. In addition to such fraud schemes, audit committees face the significant challenge of addressing the compliance risks and requirements that come with global operating models and government stimulus funds.

Companies typically design corporate compliance programs to comply with laws and regulations, internal policies and procedures and contractual obligations. However, audit committees should also be mindful of risks associated with globalization, such as compliance with the Foreign Corrupt Practices Act (FCPA).

## **Bribery and corruption**

The risk of FCPA noncompliance is more significant today as both the US Department of Justice (DOJ) and the US Securities and Exchange Commission (SEC) continue to increase their resources dedicated to FCPA monitoring and enforcement. This increased scrutiny comes at a time when many companies are increasingly focused on growing business and market share through expansion and acquisitions in the global markets. The use of foreign consultants, agents and advisors increases the risk of noncompliance in the face of even more robust regulation and oversight. Additionally, with the significant merger and acquisition activity prior to the

economic downturn, companies are at risk of inheriting FCPA-related problems resulting from the existing business practices and relationships of the acquired business.

In addition to the FCPA, similar international laws and treaties have been enacted by other foreign organizations. In 1997, the Organization for Economic Co-Operation and Development (OECD) formed the Convention on Combating Bribery of Foreign Government Officials in International Business Transactions (the Convention). Since then, 37 countries from six continents have adopted the Convention, as well as laws criminalizing bribery and tax deductions for bribe payments. Similar laws have also been enacted by the United Nations and the World Bank.

At a more regional level, countries and unions have developed similar anti-corruption legislation, such as the European Union Convention on Corruption (1997) and the African Union Convention on Preventing and Combating Corruption (2003). These conventions further demonstrate that international organizations are continuously working towards expanding their anti-corruption efforts to enforce and prosecute companies on international anti-corruption matters.

## **American Recovery and Reinvestment Act (ARRA)**

The acceptance of government stimulus funding under ARRA creates another unique challenge for companies and their audit committees. Some of these government programs include grants issued to standardize and optimize electronic health records, to construct and enhance broadband communication in areas believed to have insufficient coverage, to advance technology for electrification of automobiles, and a wide variety of other programs in construction, healthcare, telecom and other industries.



**Fraud risks facing audit committees**  
*Continued on page 8.*

# How risky are your compensation policies?

Many important business and corporate governance issues have surfaced during the financial crisis. None has incited the public's anger and resentment as much as executive compensation. Many believe that compensation policies at financial institutions and other businesses have led many executives to take excessive risks,<sup>1</sup> bringing this issue to the political forefront.

In February 2009, President Barack Obama asserted, "What gets people upset – and rightfully so – are executives being rewarded for failure."<sup>2</sup> As a result, all public company boards, regardless of industry, are under pressure to address the issue of compensation.

Reinforcing this agenda are the SEC's new proxy disclosure requirements on the links between compensation and risk, board leadership and board oversight of risk management.<sup>3</sup> Together, these pressures raise two important questions for audit committees:

1. How should companies assess the effect of their compensation policies and practices on risk-taking?
2. What is the role of the audit committee in executive compensation?

## Assessing the link between compensation and risk

For some boards, assessing how compensation policies affect risk may be a new responsibility. One audit committee chair said recently, "In the boards where I am a member of the compensation committee, I don't recall the word 'risk' ever coming up in those discussions." Even in the Compensation Discussion and Analysis (CD&A), disclosures often contain extensive information about compensation levels and policies, but typically say little about the links to risk.

Nevertheless, the escalating debate on executive compensation and risk means companies will need to develop tools that management and boards can use to understand the balance between risk and reward. One audit committee chair recently said, "Incentives matter ... but the issue is there is no one answer to this. It depends on the risk you are willing to pay for." Pay for performance exists because greater risk often means greater reward – for the company and the executive.

Another audit committee chair added, "It's about how you balance the short-term and long-term incentives. If both are high risk, it could lead to trouble."

Examples of evaluation criteria to assess the link between compensation and risk include:

- ▶ **The number and type of performance measures used to determine compensation**  
A higher number and diversity of measures may be less likely to distort behavior.
- ▶ **The materiality of compensation payouts and the amount of variable compensation**  
Payouts that constitute a higher percentage of the company's earnings, and compensation structures with very high variable pay components, constitute a risk that should be counterbalanced.
- ▶ **The extent to which employee evaluations take into account the employee's risk management practices**  
Rewarding specific practices (as well as outcomes) encourages better risk management and strengthens a culture of risk awareness.

## The role of the audit committee

Boards are actively discussing this issue, including the practical ways in which the audit and compensation committees can work together. Some of the activities audit committees are often involved in, usually with input from the external auditor, include:

- ▶ **Assessing the quality of earnings and determining the data used by the compensation committees are accurate.** An audit committee chair recently stated, "This has become a routine part of my audit committee role. We work with the external auditor and management to get together the raw material for the compensation plan."

1. Financial Stability Forum, *FSF Principles for Sound Compensation Practices* (London: Financial Stability Forum, 2009). Available at [www.financialstabilityboard.org/publications/r\\_0904b.pdf](http://www.financialstabilityboard.org/publications/r_0904b.pdf)

2. Jim Kuhnhen, "Obama Imposes Pay Cap on Executives," AP Newswire, February 4, 2009. Available at [news.aol.com/main/obama-presidency/article/obama-pay-cap-executives/328268](http://news.aol.com/main/obama-presidency/article/obama-pay-cap-executives/328268).

3. US Securities and Exchange Commission, "Proxy Disclosure Enhancements," final rule, December 16, 2009. Available at [www.sec.gov/rules/final/2009/33-9089.pdf](http://www.sec.gov/rules/final/2009/33-9089.pdf).

- ▶ **Assessing whether the metrics used to assess performance are appropriate and unlikely to encourage the wrong behavior.** An audit committee chair said, "Our audit committee approves the compensation plan. We ask, 'Does this goal make sense or not?'"
- ▶ **Reviewing the proxy statement and the related executive compensation disclosures for consistency with other disclosures in the financial statements.** The audit committee should help the compensation committee make sure that the amounts disclosed, and the related explanations, are accurate, clear and consistent with other disclosures. As one member said, "There are so many numbers in the CD&A. It would be embarrassing to get this wrong."

When it comes to disclosing the link between compensation and risk, oversight may fall to the audit committee even though the disclosure will appear in the CD&A.

However, many audit committee chairs feel unprepared to meet the SEC disclosure requirements. One said, "I'm not sure how this will play out, how companies will meet the requirements." Others have voiced frustration at the lack of SEC guidance on the matter. Another said, "I think we are going to end up with lots of verbiage in this area ... but not much that's substantive." The SEC rules were approved and finalized on 16 December 2009, in time for the 2010 proxy season.

Despite widespread public outrage over how executive compensation programs drove excessive risk taking in financial institutions, recent conversations with audit committee members from a number of industries make it clear that boards are still grappling with the implications. One audit committee chair remarked, "We've opened this up to the full board for discussion. It's healthy. And it's evolving." ✓

*Forward View is written by Tapestry Networks. Views expressed by Tapestry Networks are those of Tapestry Networks and not necessarily of Ernst & Young. Tapestry Networks convenes eight audit committee networks sponsored by Ernst & Young that collectively consist of more than 120 individuals, who chair more than 170 audit committees and sit on over 300 boards at some of the world's most admired companies.*

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4. "SEC final rule: Proxy disclosure enhancements," *Hot Topic*, 18 December 2009, Ernst & Young.

## SEC added new proxy disclosures on compensation

The SEC's amendments will require enhanced disclosure about executive compensation and corporate governance to be included in proxy materials. The rules are effective for the 2010 proxy season. The highlights of the amendments that deal with executive compensation disclosures include:<sup>4</sup>

- ▶ Recognizing that a company's broader compensation policies and arrangements for employees other than the Named Executive Officers (NEO) also may be important, the SEC amendments broaden the scope of existing disclosures. To the extent that risks arising from a company's compensation policies and practices for employees are reasonably likely to have a material adverse effect on the company, discussion of the company's compensation policies or practices as they relate to risk management and risk-taking incentives are required to be disclosed by Item 402 of Regulation S-K.
- ▶ The SEC received comments from a variety of sources that the information investors would find most useful and informative in the Summary Compensation Table (SCT) and the Director Compensation Table (DCT) is the full grant date fair value of equity awards made during the covered fiscal year. The amendments require this disclosure even if the amount of the award is earned and recognized in subsequent years. The amendments also require companies providing Item 402 disclosure for a fiscal year ending on or after 20 December 2009 to provide comparative disclosure for each preceding fiscal year required to be presented in the table. That is, the stock awards and option awards columns for previous fiscal year(s) in the SCT and DCT should present the full grant date fair values, and the total compensation column should be recomputed.
- ▶ The final rule amends Item 407 of Regulation S-K to require for the first time disclosure about the fees paid to compensation consultants and their affiliates who play any role in determining or recommending the amount or form of executive and director compensation, if they also provide other services to the company.

## Fraud risks facing audit committees

*Continued from page 5.*

Companies that previously did not operate under any form of government contracting rules now find themselves faced with new compliance requirements after accepting ARRA funds. For these companies, it is now mandatory to report the number of jobs created and saved as a result of receiving the stimulus funds and situations where they have “credible evidence” of fraud or violations of certain criminal statutes. Some grants also require auditor attestation that the funds were used for their intended purpose. Further, companies must comply with these new requirements (as well as all other federal government requirements) within an environment of rapidly increasing government oversight. Recent articles indicate that the US Congress, the US General Accounting Office, the DOJ and the ARRA Recovery Board are becoming increasingly concerned about the potential for fraud and white collar crime with respect to the ARRA legislation.

In 2009, the DOJ announced that it would be hiring a Deputy Attorney General and 10 additional attorneys to focus exclusively on white collar crime. The ARRA Recovery Board announced that it has already referred approximately 100 cases of potential fraud by entities who have been awarded ARRA grants and contracts to the various agencies of the Offices of Inspectors Generals.

### Going forward

Economic pressures and new business relationships can significantly affect the risk profile of a company. Audit committees need to be aware of circumstances where their companies may have received government funding and confirm that appropriate processes and internal controls are in place to establish and maintain effective compliance in the areas of fraud risk affecting financial reporting, and in areas of evolving FCPA and ARRA risks. ✓

### Questions for the audit committee to consider

- ▶ Does the company’s corporate compliance program monitor bribery and corruption risks that could affect financial reporting?
- ▶ Does the company have appropriate processes and controls in place to assess compliance with pertinent global laws and regulations?
- ▶ Did the company accept any stimulus funding under ARRA? If so, what processes and controls are in place to assess compliance with the requirements associated with receiving ARRA funds?

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