Disclosures and Audit Committees Are Key in Turbulent Times

Lessons learned from the use of fair values in times of market turmoil underscore the need for careful disclosures and bring new challenges for audit committees.

As companies scrambled to timely adopt FASB Statement No. 157, *Fair Value Measurements*, amidst the turbulent credit market conditions of the first quarter of 2008, three important developments emerged that will help shape the future of financial reporting and governance. First, the debate over the pros and cons of fair value accounting became more heated and more urgent. Second, the SEC responded with a set of suggested disclosures designed to help investors make sense of the First Quarter Form 10-Qs. Third, audit committees in companies of all sizes and industries started to come to grips with a new set of governance issues.

To help companies tackle the new challenges, this Client Advisory highlights the reasons why careful attention to disclosures is important, explains the additional disclosures suggested by the SEC staff, and lists steps that companies can take to strengthen their disclosures and address the emerging governance issues.

Steps to Consider

In formulating their response, audit committees should consider the following steps:

- Assess the impact of the market turmoil.
- Evaluate the use of fair value accounting and "mark-to-market" measures.
- Oversee the adequacy of related disclosures.
- Investigate accountability for credit losses.
- Evaluate the company's controls over risk and liquidity.
- Consider changes in the structure of the board and the roles of the directors.
- Agree with the external auditor on the extent of procedures performed during interim reviews.

Consultations with the external auditor can be helpful in taking the above steps.

Reasons Why Disclosures Are Important

Strong disclosures have emerged as a critical success factor due in part to the level of judgment required to apply Statement 157, especially in times of uncertainty when some securities are not traded on active markets. At uncertain and stressful times like this, careful attention to disclosures can strengthen the financial reporting process by shedding additional light on areas that are more important in tough times. For example, disclosures can help companies, investors, and directors in the following ways.

- *Disclosures can help companies put "paper losses" in perspective.* Some corporate executives have expressed concerns over the "paper losses" that can result from the combination of fair value accounting with the current market conditions. These concerns relate to the use of fair values for assets and liabilities whose fair value must be based on unobservable inputs (known in Statement 157 as Level 3 inputs). A key fear is that the use of fair

value accounting focuses too much attention on losses that are based on shortterm market conditions and do not necessarily reflect ultimate realizable values. These losses can cause investors to over-react and exacerbate the adverse effects of illiquid market conditions. Supplemental disclosures are a way to add a longer-term perspective.

- *Disclosures can help investors avoid surprises*. Investors appear to have become more cautious now. Many are seeking more information, so they can protect their investments from surprises like the one that occurred during the past quarter, when the news broke that the Federal Reserve Bank had rescued a major brokerage firm from impending bankruptcy. This was just one of several companies that seemed healthy as recently as calendar year-end but underwent significant changes in liquidity during the first quarter of 2008. Greater disclosures about liquidity-related risks are a way to help avoid or at least mitigate these types of unpleasant surprises.

Disclosures can add a longer-term perspective and help investors avoid unpleasant surprises.

- Disclosures can help audit committees prevent expectation gaps. Large unexpected losses and seemingly sudden demises of companies can cause declines in shareholder value and focus attention on the role of the board of directors. For example, unforeseen losses and bankruptcies can raise questions about the adequacy of internal control reporting. In some cases, shareholders have blamed audit committees for a lack of oversight. Already, the chair of at least one prominent company's audit committee has stepped down from his position in response to investor reactions. These situations can also lead to sweeping regulatory investigations. Careful attention to disclosures can help avoid these types of problems by setting realistic expectations. Just as important, good disclosures can help avoid costly litigation that might otherwise arise with the benefit of hindsight as investors question whether the company was aware of an impending loss and failed to adequately disclose the risk.

Steps to Strengthen Disclosures

In times of credit market stress, audit committees may find it useful to have a framework for asking management about: (a) the risks inherent in the environment, (b) any issues that arose in connection with Statement 157, and (c) the extent of any voluntary disclosures made in connection with the risks or the adoption of the standard. Below are suggested steps to help audit committees structure their oversight of these areas.

1. *Assess the effects of uncertain markets*. In view of the turmoil of the first quarter, the audit committee should make appropriate inquiries about the impact of the credit crisis on the company and any resulting changes to internal controls. These questions may include the following:

   - Have there been any changes in the process by which the company manages its liquidity needs? (This would include the process by which the company determines and meets its need for additional capital or financing.)

   - Have there been any changes in the availability of credit that might have a significant effect on the company? (Examples: Any credit rating downgrades or changes in the financial health of the company's banks and other creditors.)

   - Are there any potential liquidity-related risks? (Examples: any potential loan covenant violations or any projected difficulty in raising capital in the future.) These questions will help assess and, if necessary, strengthen the company's disclosures about risks and uncertainties.

2. *Evaluate the use of fair value accounting and "mark-to-market" measures*. The audit committee should also make suitable inquiries of management and the external auditors about the company's application of Statement 157. Sample questions:

   - How did the company identify the assets and liabilities to which Statement 157 applies in the current quarter? To what extent did the external auditors review this work?

   - Were there any significant changes since year-end in the market values of the company's investments or any changes in the nature of the investments, such as refinancing of auction-rate securities?

   - Have the auditors reviewed the classification of the auction rate securities? If there was any conversion of these securities to other types of instruments, have the external auditors reviewed the accounting implications?

- What techniques and/or models were used for Level 2 and 3 assets? Were there any significant changes in the assumptions during the period?

- Has management obtained an appropriate understanding of any models or assumptions that underlie values reported by brokers or pricing services?

The responses to these questions will help evaluate the quality of the company's financial reporting and provide a starting point for assessing the adequacy of the company's disclosures about fair value measurements.

3. *Consider the adequacy of related disclosures*. The audit committee should consider the adequacy of the disclosures made in the footnotes, MD&A, and risk factors. Sample considerations include the following:

   - Has the company included all the disclosures required by Statement 157? (Because the standard took effect during the first quarter, all annual disclosures must be made in the first quarter financial statements of SEC registrants.)

   - Has the company made the voluntary disclosures suggested by the SEC?

   - Does the external auditor have any recommendations with regard to the disclosures?

SEC's Suggested Disclosures

Background	Level 3 Assets and Liabilities	All Items Measured at Fair Value
In March 2008, the SEC's Division of Corporation Finance responded to the difficulties in the financial markets by sending letters to the CFOs of major financial institutions. The institutions selected for the letters were those whose most recent annual reports on Form 10-K reported significant amounts of items whose values might be at risk in today's market conditions. These items include assetbacked securities, loans carried at fair value or the lower of cost or market, and derivative assets and liabilities. The letters highlight disclosure matters relating to Statement 157 and suggest the companies consider these matters as they prepare their Forms 10-Q. Consideration of these disclosures may also help companies in other sectors. The letters asked the CFOs to consider two categories of additional disclosures: Level 3 assets and liabilities and all items measured at fair value.	The following disclosures apply to Level 3 assets and liabilities: • The portion of total assets and liabilities measured at fair value that consists of Level 3 asset and liabilities, plus information about material re-classifications between Level 3 and Levels 1 or 2. • A discussion of inputs that are no longer considered to be observable, along with disclosure of any material resulting gains or losses that are excluded from the Level 3 reconciliation required by Statement 157. • A discussion of the reasons for any material gains or losses in Level 3 assets and liabilities, along with an explanation of how the gains or losses on Level 3 assets and liabilities affect the company's profitability, liquidity or capital resources. • Management's assessment of whether the ultimate realizable value of the Level 3 assets and liabilities will differ from the fair values reflected in the 10-Q, and, if so, why. A breakdown of the nature and type of any asset-backed securities, the years of issuance, and the credit ratings, including any changes or potential changes in these ratings.	The following disclosures apply to all assets and liabilities measured at fair value, regardless of where they fall within the Statement 157 hierarchy: • A general description of the valuation techniques or models used for material assets and liabilities, along with any material changes made to these techniques and the resulting impact. • A discussion of any market indices, such as the ABX or CMBX indices, used in connection with the techniques or models, along with any adjustments made during the quarter based on these indices, and the reasons for the adjustment. • A discussion of how the company validates the techniques or models used. • A discussion of how sensitive the fair value estimates for material assets and liabilities are to the significant inputs used in the techniques or models. If material, a discussion of how increases or decreases in the aggregate fair values of the company's assets and liabilities may affect the company's liquidity and capital resources.

Emerging Issues for Audit Committees

Audit committees have become a target for blame for the losses and declines in shareholder value resulting from the subprime fallout. The 2008 proxy season saw a flurry of shareholder resolutions calling for diverse changes in governance and special reports. Although financial services companies may have borne the brunt of the losses, the concerns of investors also raise questions for audit committees of other companies, especially those that are involved in businesses related to residential housing, and those that hold investments in risky assets.

To help audit committees identify potential areas for improvement, below are a few self assessment questions derived mainly from recent regulatory reports and shareholder demands.

1. **If the company has (or could have) significant investment or credit losses, are the disclosures adequate?**

   Over the past few months, as shareholders have read about the credit crisis and the surrounding media coverage of the perceived flaws in fair value or "mark-to-market" accounting, companies have received shareholder resolutions asking for fuller disclosures about subprime loans, potential financial exposures and business implications. In formulating a response to these resolutions, a good starting place is the SEC's suggested list of disclosures as summarized on page 4 and available at http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0308.htm. Another source is the list of questions for management and directors in our Client Advisory on "Financial Reporting in Turbulent Markets" available at http://www.bdo.com/download.aspx?id=754.

2. **Has the company investigated and assigned accountability for the losses?**

   This question is on shareholders' minds this year; some seek to hold the directors accountable while others want to hold management accountable. Often, there is no easy answer to the accountability question. The first step is to determine whether the losses are confined to a particular operating unit or reflect systemic company-wide problems. The next step may be an evaluation of management's organization and processes. One key consideration is whether the company should have a chief risk officer. Other considerations are whether risk policies are effectively communicated and valuation practices consistently applied throughout the company. If the evaluation indicates a need for improvement, the committee should consider the steps needed to achieve the goals.

3. **Are the company's controls over risk and liquidity adequate to prevent surprises for investors in the future?**

   Regulators have been studying the corporate risk management practices that led to the current credit crisis. A report by the senior financial supervisors from five countries indicates that the companies with the greatest problems tended to have weaker controls over their potential balance sheet growth and liquidity. Audit committees that have not focused on these types of controls may wish to explore the related issues and best practices. The full report, "Observations on Risk Management during the Recent Market Turbulence," is available at http://www.sec.gov/news/press/2008/report030608.pdf.

4. **Do audit committee members have appropriate expertise and time to provide oversight of risk management?**

   Audit committee members are selected for their objectivity, independence, and financial literacy as well as their overall business knowledge. Although they are trained to assess financial reporting risks, some may not be as well-qualified to assess credit, liquidity and operational risk. A key question is whether audit committee members need additional training or resources (such as outside consultants) to meet shareholder expectations about any risk management responsibilities incorporated in the audit committee's charter.

issuing company's relationships with these agencies. In some cases, shareholders are asking about hiring policies that might create potential conflicts of interest. Labor unions have filed shareholder resolutions at some companies asking that the audit committee expand its role to include oversight of relationships with credit rating agencies. The fallout indirectly affects other companies that purchase or hold investments and rely on credit ratings. Audit committees of these other companies may benefit from assessing how these governance issues might affect management's investment policies and reliance on ratings.

7. Does the board need a separate compliance committee?

After hearing of rising defaults and foreclosures on subprime mortgages, shareholders of companies with non-regulated financial arms, such as homebuilding companies with mortgage lending operations, have grown concerned that consumers (individual home-buyers) are not getting sufficient information to make informed decisions. In some cases, shareholders are asking if the company has formed (or plans to form) a compliance committee composed of outside directors to ensure that loan terms and underwriting standards are consistent with prudent lending practices. These requests are specific to the home-building industry and subprime crisis, but they may contain the seeds of best practices for directors of companies in other industries as well. The overarching lesson is that boards may be called upon to oversee the adequacy of disclosures to customers as well as investors, and they may need to re-assess their roles related to the companies whose risks and financial results they oversee.

Related considerations include the adequacy of the disclosures in audit committee reports about the levels of attention and expertise devoted to oversight of risk management.

5. Should the board consider a change in its structure?

As the responsibilities of audit committees have increased in recent years, some audit committees may have become overburdened and may have delegated their responsibility for oversight of risk management, (e.g., to a finance committee or an asset quality committee). Some boards may find they have ended up with committees that have overlapping duties. There is no one solution to the question of the best structure of the board. But corporate structures for oversight of risk management are in the spotlight today, and audit committees may want to consider this matter and, if necessary, update any statements about the assignment of duties for oversight of risk management on the company's website or in its proxy statement.

6. Does or should the audit committee oversee the company's relationships with credit rating agencies?

A number of financial institutions have incurred losses on investments that had excellent credit ratings, causing investors to be skeptical of the credit rating agencies and the

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8. **Does the audit committee have a solid grasp of the requirements of FASB Statement 157?**

   The application of Statement 157 in these uncertain times adds to the complexity of the audit committee's role. If audit committee members do not already have an understanding of the requirements of this standard, they should consider attending a training course or asking their auditors for an overview. BDO Seidman has resources available to conduct briefing sessions, if desired. In addition, we provided a summary of the standard and a list of questions for management and directors to consider in our Financial Reporting letter on the changes and challenges in accounting for 2008. The summary and questions may be especially helpful for first quarter 2008 SEC filings. The letter is available at http://www.bdo.com/download.aspx?id=760.

9. **Does the audit committee have a good understanding of the extent of the procedures performed by the external auditor?**

   The procedures in an interim review differ significantly from those performed in an audit. The distinction between the two is especially important in turbulent times like this when more procedures are likely to be necessary in order to determine the proper valuation and disclosures. In an interim review, an auditor considers whether there is reason to believe the interim financial information may not be in conformity with GAAP. This generally relies on the auditor's understanding of the company's business and controls, as well as inquiries of management and others and certain analytical procedures. A review therefore is not intended to provide the same level of assurance as an audit or to ensure that the auditor will become aware of all significant matters that would be disclosed in an audit.

10. **Does the audit committee understand the relevant metrics and the riskiest parts of the company's balance sheet?**

    A common trait of financial analysis is that it typically uses ratios and metrics that are calculated as averages, rather than presented as ranges. This technique can lead to a condition that might be described as "presumed precision," that is, a false sense of security that can mask the full range of variations and underlying risks. Another problem is that the metrics often used as key performance indicators by companies and analysts can focus too much attention on short-term results, such as earnings per share, at the expense of long-term growth and shareholder value.

    An initiative that audit committees may find interesting is the establishment of the Aspen Principles on *Long-Term Value Creation: Guiding Principles for Corporations and Investors.* These principles are particularly important in an age where shareholders are demanding a "say on pay" and want executive pay to be tied to long-term performance metrics. The principles call for development of effective long-term metrics and reporting to investors. A copy of the principles is at *http://www.aspeninstitute.org/atf/cf/{DEB6F227-659B-4EC8-8F848DF23CA704F5}/FinalPrinciples.pdf.* ■

For more information

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