Public Company *Insights*

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How effective is your audit committee?

The Sarbanes-Oxley Act of 2002 (SOX) dramatically changed the audit committee's role in public companies. Previously, the committee oversaw the financial reporting process.

Today, the audit committee — not management or the full board — is *directly* responsible for appointing, compensating and overseeing external auditors and preapproving audit and nonaudit services provided by the auditor. Given the critical role your audit committee now plays, it should be evaluated periodically. One way is for the committee to perform annual self-evaluations.

Why self-evaluation?

The American Institute of Certified Public Accountants (AICPA) and other organizations recommend that audit committees conduct an annual self-evaluation. And if your company is listed on the New York Stock Exchange, self-evaluation is required.

The process offers several important benefits, such as helping your audit committee:

- Improve its performance,
- Promote candid discussions,
- Identify practices and procedures that will help it conduct more effective meetings,
- Enhance its ability to evaluate your company's internal and independent auditors, and
- Boost its ability to assess fraud risk.

Self-evaluation also helps ensure that the committee satisfies SOX requirements, SEC rules and stock exchange listing standards. For example, under SOX, each committee member must be independent of company management, and the company must designate at least one member as a "financial expert" (or explain why the committee doesn't have one).

Also, Public Company Accounting Oversight Board standards require a company's independent auditors to evaluate the audit committee's effectiveness. Self-evaluation can assist the auditors in conducting their own assessment and help your committee anticipate problems.

Finally, self-evaluation is increasingly recognized as a "best practice" in corporate governance circles. For this reason, self-evaluations — together with other best practices — can provide the audit committee and your company with some protection in the event the committee's performance is questioned in a lawsuit or regulatory action.

What are the risks?

Self-evaluation isn't without risks. The biggest one is that negative findings could provide ammunition for regulators or plaintiffs in actions against your company, audit committee members or the board of directors. Such findings are particularly dangerous if your company fails to take corrective action.

Other risks depend on the approach a company takes to self-evaluation. (See "A flexible process" at right.) For example, an assessment process that scrutinizes individual performance may alienate audit committee members.

How do you reduce downside?

Typically, the evaluation process begins with a questionnaire that identifies issues to be discussed in a self-evaluation meeting. It's impossible to eliminate the risk that the questionnaire will generate potentially damaging evidence, but you can minimize the risk. By involving legal counsel in the process, for example, you might be able to gain some protection from the attorney-client privilege.

The most effective approach, however, is to phrase questions in terms designed to elicit ideas for improvement rather than to highlight weaknesses. Your questions should focus on process improvement rather than soliciting members' conclusions on the adequacy of your company's financial reporting processes. For example, avoid questions like, "Do you feel that the company's internal controls are adequate?" Instead ask: "Has the audit committee reviewed all significant control deficiencies identified by the internal or independent auditors?" "Does management's corrective action plan and timetable address those recommendations?" "How can we be more effective as a committee?"

If the list of questions asks members to rate some aspect of the committee's performance, use a scale with terms like "strong" or "excellent" at one end and "less strong" or "needs improvement" at the other. Avoid using terms such as "weak," "inadequate" or "poor." If your audit committee's self-evaluation identifies any areas

A flexible process

There's no one right way to conduct an audit committee self-evaluation. Even though the committee itself is responsible for the evaluation, it can still enlist outsiders for assistance. Some companies, then, do it strictly in-house, while others use outside evaluators. Some rely on written questionnaires, while others use personal interviews.

The process itself can take different forms and involve a variety of participants. According to the American Institute of Certified Public Accountants' Audit Committee Effectiveness Center, common approaches to self-evaluation include:

Introspection. The committee members — and, possibly, the board chair — evaluate the committee's performance by answering specific questions about the committee's impact on the financial reporting process and its relationships with management and internal and independent auditors.

360-degree. Each committee member (including the chair) evaluates all of the other members.

Performance improvement. The chief audit executive, CFO, CEO and independent auditor are asked to comment on the committee's performance.

Competency. The committee, others within the company or an outside evaluator assesses the financial literacy of committee members. They look at, among other things, recent training on enterprise risk management, accounting, auditing, financial reporting developments and current business and industry practices.

Leadership. The committee members discuss the committee chair's performance, communicating any concerns to the board chair or the chair of the corporate governance committee.

Whichever approach your company uses, it should enable candid discussions about the committee's effectiveness and provide a roadmap for improvement.

that need improvement, committee members must follow up and make any necessary changes.

To minimize the risk of alienating committee members, consider beginning the process by assessing the committee's overall performance and processes rather than evaluating individual performance. Member performance reviews can come later if the initial self-evaluation raises individual performance issues.

Get help

Whether your company is required to perform audit committee self-evaluations or you elect to conduct them, careful planning is critical to maximizing the benefits. Your accounting and legal advisors can help you design an effective self-evaluation process. In addition, the AICPA and several corporate governance organizations have created self-assessment tools that you can customize to meet your company's specific needs.

What to do when your stock options are underwater

Although the economy is gradually improving, many public companies' stock prices remain depressed. In some cases, stock options held by key employees are "underwater" — their exercise price exceeds the stock's current fair market value. Some companies have responded to the problem by repricing underwater options. But this strategy is more difficult to deploy than it was in the past, and it comes at a cost.

Incentive turns to disincentive

Stock options are designed to incentivize employees by aligning their interests with those of the company and its shareholders. Unfortunately, when options go underwater, it hurts both the employee and the company. Under current accounting rules, companies must measure the fair market value of options on the grant date, using the Black-Scholes valuation formula or another option-pricing model, and expense that value over the vesting period.

If a stock's price falls below the option exercise price, the company is left with a significant compensation expense for an incentive that's lost its power to motivate. In fact, underwater options can make their holders more receptive to offers from other companies.

Shareholder approval is critical

If you're concerned about retaining talent, consider repricing underwater options. Typically, this involves exchanging old options for new ones or for restricted stock shares. But before you reprice options, obtain shareholder approval and consider other potential risks and costs.

The New York Stock Exchange and NASDAQ require listed companies to obtain shareholder approval unless their compensation plan permits option repricing without it. Even if shareholder approval isn't mandated, obtaining it is a good idea. Proxy voting advisory services may recommend "against" votes for compensation committee members at companies that reprice options without shareholder approval.

If you seek shareholder approval for repricing options, keep in mind that you must comply with the SEC's proxy solicitation rules. You may also need to comply with the SEC's tender offer rules.

Exchanges can be tricky

Typically, shareholders don't like option repricing because they feel that it's inconsistent with the purpose of stock options — to share with employees both the rewards and the risks of equity ownership. And shareholder approval will be difficult to obtain unless the terms of the exchange are favorable to public shareholders. So it's extremely unlikely that you'll win approval of "one-for-one" exchanges of underwater options for an equivalent number of new options at the current market price and with similar vesting terms.

If you're concerned about retaining talent, consider repricing underwater options.

Proxy voting advisory service guidelines generally call for "value-for-value" exchanges, where the value of new options or restricted shares is roughly equal to the value of the surrendered options. This means that the new options or securities are likely to cover a substantially smaller number of shares. Guidelines may also exclude directors and top officers from repricing.

Under current accounting rules, value-for-value exchanges generally don't result in additional compensation expense. But if the repricing involves a one-for-one exchange or other employee-favorable terms, incremental compensation charges could be substantial. Any remaining compensation expense associated with the surrendered options will continue to be recognized.

From a tax perspective, option repricing shouldn't immediately result in income to employees or a deduction for the company. Also, repriced options are considered "new grants" for purposes of Internal Revenue Code Section 162(m), which imposes a $1 million limit on deductible compensation — including certain stock options — paid to CEOs and certain other executives.

Communication is key

To reprice underwater options, you'll need to convince shareholders that it's in the company's best interests and that the program's terms are fair. But before you approach shareholders, talk to your advisors about potential compliance, accounting, tax and investor relations implications.

New IRS schedule would require tax uncertainties disclosure

The Financial Accounting Standards Board's Financial Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, is part of a trend toward greater financial transparency and accountability on the part of U.S. companies. FIN 48 now is included in Accounting Standards Codification (ASC) 740.

Starting with the 2010 tax year, the IRS plans (as of this writing) to mandate that certain large corporations make even more detailed disclosures about uncertain tax positions on their returns. It's a controversial move because it, in essence, asks companies to provide the IRS with a roadmap for identifying potential tax return weaknesses.

GAAP compliance

FIN 48 requires public companies, and other companies that prepare GAAP-compliant financial statements, to review all of their federal and state tax positions and determine whether it's "more likely than not" that they would withstand a challenge by the IRS or a state tax authority. Such positions include decisions not to file in a particular state. Tax benefits that fail this test aren't recognized in the financial statements.

For other tax positions, a company must establish reserves to cover the portion of certain tax benefits that may be disallowed and disclose this information in their financial statements. FIN 48, therefore, has been of limited value to the IRS, because it requires disclosure of only aggregate amounts, not itemized details about uncertain tax positions.

IRS proposal

In January 2010, the IRS made public its proposal to require large corporations to disclose uncertain tax positions on their tax returns. In April, the IRS released draft Schedule UTP ("Uncertain Tax Position Statement") with draft instructions.

Corporations with assets of $10 million or more and that issue audited financial statements are directed to report uncertain tax positions on Schedule UTP. The new rules are scheduled to be effective beginning with 2010 tax returns.

According to the draft instructions, a company must report a tax position taken for the current tax year or a prior tax year if it either:

1. Recorded a reserve with respect to the tax position at least 60 days before filing its return, or
2. Made a decision, at least 60 days before filing the return, *not* to record a reserve based on an expectation to litigate or an IRS administrative practice.

Unlike financial statement disclosures, which are limited to aggregate amounts, Schedule UTP requires itemized detail. Among other things, a company must:

- Provide a "concise description" of each uncertain tax position,
- Cite the primary Internal Revenue Code sections involved,

- State whether the tax position creates a temporary or permanent difference — or both, and
- Calculate the maximum tax adjustment (MTA) or, in the case of valuation or transfer pricing issues, provide a ranking.

The MTA is an estimate of the maximum amount of potential federal income tax liability associated with the tax year for which a tax position was taken.

Next steps

The IRS was accepting comments on its draft schedule and instructions until June 1. Most observers expect its fundamental principles to remain intact when the schedule is finalized, but check with your tax and accounting advisors for the latest information. In the meantime, evaluate the potential impact of Schedule UTP on your tax returns and, if appropriate, consider taking steps to eliminate any uncertain tax positions.

Effective whistleblower procedures pay off

You're probably well aware that the Sarbanes-Oxley Act's (SOX's) "whistleblower" provisions require your company's audit committee to establish procedures for handling employee complaints. But it's a good idea to review the provisions from time to time to ensure your company is in compliance.

Go beyond compliance

Under SOX, your audit committee must: 1) receive, retain and treat complaints regarding accounting, internal control or auditing matters, and 2) allow employees to make confidential, anonymous submissions regarding questionable accounting or auditing matters.

According to the Association of Certified Fraud Examiners' *2010 Report to the Nations on Occupational Fraud and Abuse*, "Three times as many frauds in our study were uncovered by a tip as by any other method," including management reviews and internal and external audits. So it pays to go beyond mere compliance and establish a comprehensive complaint-handling process. Your procedures should make it easy for employees to make reports and for you to follow up on them.

Enhance your process

Make sure you've set up multiple mechanisms for employees to make "confidential, anonymous submissions." Offering more than one improves the chances that employees will find a mechanism that they're comfortable with. Examples include internal hotlines, external hotlines, Internet-based reporting and independent third parties.

You also need to have detailed procedures for screening complaints. To ensure the integrity of the process, consider asking an independent group to conduct initial screening. Once you've determined that a complaint is relevant, analyze its potential impact. Your procedures should help you decide which advisors (attorneys, forensic accountants, auditors or law enforcement) need to be involved in the investigation.

Communicate, communicate, communicate

Of course, your whistleblower program works only if employees are familiar with it and with the proper procedures for making complaints. Communicate the fact that your company takes complaints seriously and is mindful of privacy and confidentiality concerns, and moves quickly to take corrective action.

Also keep whistleblowers and other interested parties informed about the progress of any complaints. When you reach a conclusion, swiftly clear those wrongly accused and punish guilty parties. Even if a complaint is frivolous or unrelated to accounting or auditing matters, it's important to respond and explain why corrective action is unnecessary.

Last but not least

Failure to protect whistleblowers against retaliation not only violates SOX, but exposes your company to considerable legal liability. By reviewing your whistleblower procedures periodically, you can both ensure you're in compliance with SOX and increase the likelihood you'll detect occupational fraud.

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