

Audit Committee Brief



Financial Literacy

Recent economic events have resulted in increased scrutiny of financial reporting. They also have shed light on the complexity of accounting standards. Given audit committees' significant responsibility for financial reporting oversight, it may be wise to consider whether enhancement of the members' financial literacy is advisable in response to current challenges and ongoing developments in accounting standard-setting.

Audit Committee Financial Literacy Requirements

Section 407 of the Sarbanes-Oxley Act requires the annual report filed on Forms 10-K, 20-F, or 40-F to disclose whether the audit committee includes at least one audit committee financial expert (ACFE). If the audit committee does not have an ACFE, the company's filing must disclose the reason why

Similarly, NASDAQ listing standards require that all audit committee members be able to read and understand financial statements at the time of their appointment to the committee, but require only one "financially sophisticated" audit committee member. The NYSE listing standards indicate that an individual who is deemed to be an ACFE satisfies the NYSE's definition of "accounting or related financial management expertise." Likewise, the NASDAQ listing standards state that an ACFE is "financially sophisticated."

Assessing and Maintaining Financial Literacy

It is a leading practice for companies to have a formal process for assessing the financial literacy of their audit committee members. To help evaluate whether an individual meets the definition of an ACFE, the AICPA developed a decision tree, which is included on page 3. In addition, Deloitte has published a [financial literacy toolkit](#) to assist company management and audit committee members in evaluating their own financial literacy.

To maintain and enhance financial literacy, it is important for audit committee members to invest the time needed to understand the latest financial reporting developments—especially those that are most critical for their industry and company. Although critical accounting areas vary by industry and issuer, the following are topics on which audit committees may wish to focus their continuing education.

Fair Value

Fair-value accounting has been the subject of much debate and scrutiny during the financial crisis. Over the past year, various guidance and proposals have been issued in this area (SFAS 157 and associated FSPs/Measurements and Disclosures [ASC820]), and additional standard-setting efforts are expected in the near future. Determining fair value can be a complex exercise in the absence of observable market prices or in distressed markets. Thus, appropriate disclosure is critical to financial statement users. Much of the recent guidance

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it does not have such an individual. In addition, the SEC requires disclosure of the name of the ACFE and whether that individual is independent of management. It is considered a best practice to have multiple ACFEs.

The NYSE requires all audit committee members to be "financially literate" as interpreted by the business judgment of the company's board, or to become financially literate within a reasonable period after being appointed to the committee. The NYSE also requires one member to possess "accounting or related financial management expertise."

Audit Committee Financial Literacy Recommendations

- Self-assessment should be thorough, not merely a compliance exercise, and should be repeated periodically.
- Members should understand complex accounting and reporting areas and how management addresses them.
- Committees should anticipate and understand how pending financial reporting and regulatory developments may affect the company, particularly its talent needs.
- Members should focus on committee composition, including independence, financial expertise, broad business or leadership experience, and succession planning.

relates to fair value. Audit committee members should focus on management's process for addressing the implications of fair-value accounting and disclosure guidance for their company's financial statements. Deloitte has published many resources regarding fair value, which are discussed in the [April 2009 Audit Committee Brief](#).

Consolidation and Off-Balance-Sheet Structures.

Two new consolidation-related accounting standards are likely to have an effect on companies (SFAS 166 & 167/Consolidations [ASC810]), especially those

with off-balance-sheet structures. These standards focus on financial assets and consolidation of variable-interest entities. Audit committee members should understand the financial reporting implications of these standards, including the potential consolidation of qualified special-purpose entities and amended criteria for consolidation of variable-interest entities. [Deloitte's September 2009 Audit Committee Brief](#) addresses the implications of this new guidance and includes questions audit committees should consider asking management.

Business Combinations. New guidance on business combinations significantly changes how companies account for such transactions (SFAS 141(R)/Business Combination [ASC805]). Among other things, the guidance expands the scope of business combinations by broadening and clarifying the definition of a business, and it will likely result in more volatility in earnings. For example, the new guidance requires an acquirer to recognize liability-classified contingent consideration arrangements (i.e., earn-outs) at the fair value as of the acquisition date, with any subsequent changes in fair value reflected in earnings rather than as an adjustment to goodwill.

In a March 2009 poll conducted during the Deloitte webcast, "Valuation under SFAS 141(R): What Implementation Lesson Are We Learning," 44 percent of the responding executives said the recent guidance would cause them to rethink deal strategy and/or the impact of planned deal activity.¹ Audit committee members should understand companies' plans to change their approaches regarding mergers, acquisitions, and other ownership transactions and how the change in guidance will affect financial reporting.

IFRS. SEC Chairman Mary Schapiro and Chief Accountant James Kroeker recently indicated that the SEC's proposed IFRS roadmap will be a renewed priority in the fall. In addition, at their September summit in Pittsburgh, the leaders of the G-20 countries called for international accounting bodies to redouble their efforts to achieve a single set of global accounting standards and complete their convergence project by June 2011. It will be important for audit committee members to begin to develop an understanding of the standards and how they differ from U.S. GAAP in areas that are significant to the company's accounting policies. Audit committee members

also should work with management to understand its process for monitoring international standard-setting activities and their potential implications, as well as the SEC's next steps and the timing of U.S. transition to IFRS. Depending on the skills of current members and the timing of potential succession of future members, the audit committee may want to consider IFRS skills in succession planning to have the appropriate expertise in place when it is needed. Further information is available on the [Center for Corporate Governance's IFRS page](#).

XBRL. XBRL (eXtensible Business Reporting Language)—also referred to as "interactive data"—is an international format for business information. XBRL provides benefits in preparing, analyzing, and communicating business information through cost savings, efficiency, and consistency of data. Audit committee members should consider how XBRL is affecting the company with respect to cost savings, benefits, risks, reporting requirements. Under the SEC's recent rules requiring a phase-in of XBRL, the largest issuers began submitting XBRL-tagged filings for the second quarter of 2009. Further information is available on the Center for Corporate Governance's [XBRL page](#).

FASB's Accounting Standards Codification. The previous GAAP hierarchy consisted of four levels of authoritative accounting and reporting guidance (levels A through D), including original pronouncements of the FASB, EITF abstracts, and other accounting literature promulgated by accounting standard-setters. As of July 1, 2009, the FASB's Accounting Standards Codification eliminated this hierarchy and replaced previous GAAP (other than rules and interpretive releases of the SEC) for all nongovernmental entities with just two levels of literature: authoritative and nonauthoritative. The codification significantly changes the way users refer to GAAP and research accounting issues. Additional information regarding the FASB's codification is available in Deloitte's May 20 *Heads Up* article, "[What Preparers Need to Know about the FASB Codification](#)," on the Center for Corporate Governance Web site.

Questions for Audit Committees to Consider

- Are audit committee members completing routine financial literacy self-assessments?
- Is the financial literacy self-assessment updated to reflect current developments?
- Has the audit committee considered the implications of IFRS when discussing a succession plan for members?
- Are modifications to the committee's education plan necessary as a result of the current environment?
- Are the audit committee's training and education programs designed to maintain financial literacy?

¹ Survey participants were self-selected and responded through a Web-based survey. Polling results are solely the thoughts and opinions of survey participants and are not necessarily representative of the total population of financial professionals. This financial reporting Dbriefs webcast was held on March 11, 2009, and had 2,025 attendees.

ACFE Defined

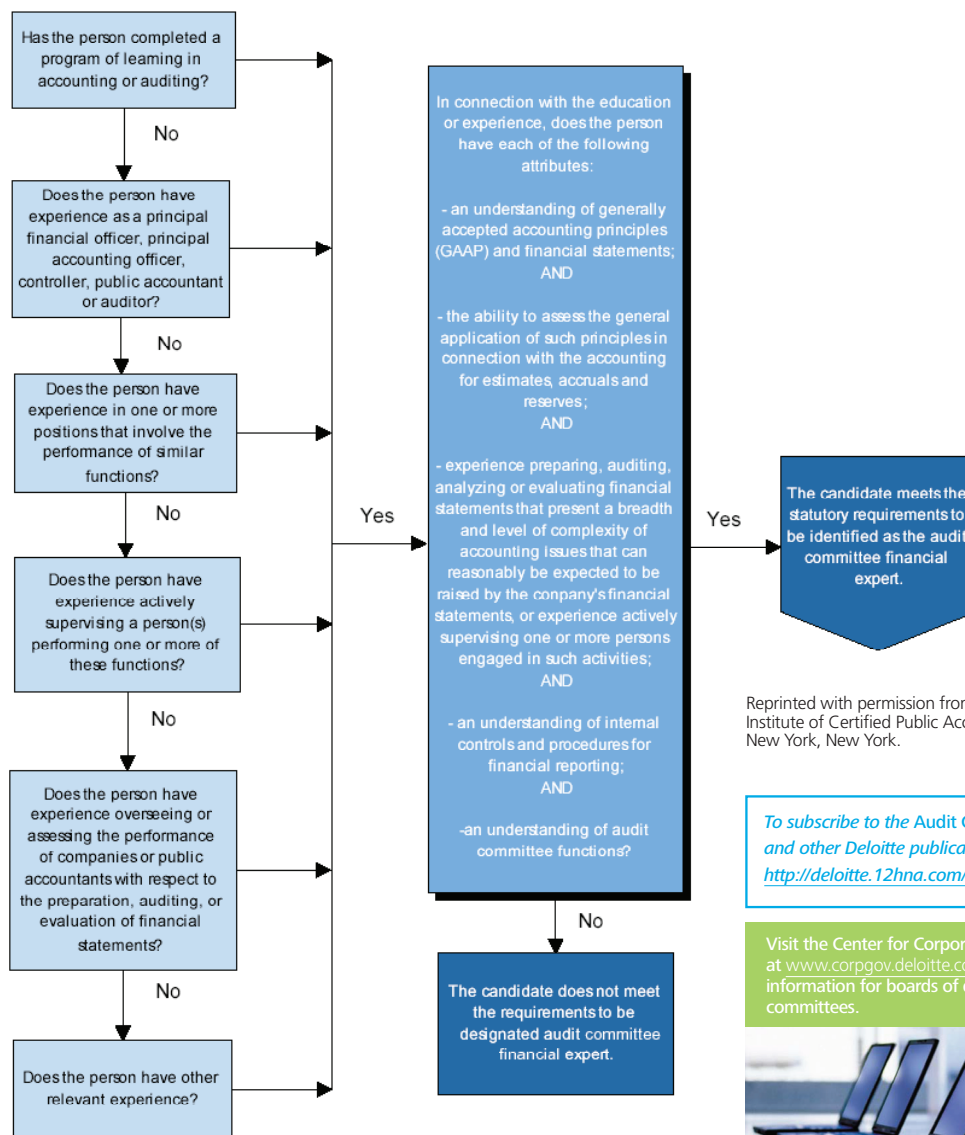
The SEC defines the ACFE as an individual who possesses all of the following attributes:

- An understanding of financial statements and GAAP
- The ability to assess the general application of GAAP in connection with the accounting for estimates, accruals, and reserves
- Experience preparing, auditing, analyzing, or evaluating financial statements that present a breadth and level of complexity of accounting issues generally comparable to the breadth and complexity of issues that can be expected to be raised by the registrant's financial statements, or experience actively supervising those engaged in such activities
- An understanding of internal controls and procedures for financial reporting
- An understanding of the audit committee functions.

The rule indicates that the attributes may be acquired by any one or more of:

- Education and experience as a principal financial officer, principal accounting officer, controller, public accountant, or auditor, or experience in positions that involve similar functions
- Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor, or someone performing similar functions
- Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing, or evaluation of financial statements
- Other relevant experience.

AICPA Audit Committee Financial Expert Decision Tree



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