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Risk Oversight Alert: Financial Reporting Risk In The Current Environment

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Moderator:

- Kenneth Daly, NACD President and CEO

Presenters:

- Robert H. Herz, Chairman of FASB
- Lewis H. Ferguson, Partner, Gibson, Dunn & Crutcher LLP

Robert H. Herz, Chairman of the Financial Accounting Standards Board

Robert H. Herz has served as chairman of the Financial Accounting Standards Board since 2002, and was reappointed to a second term effective July 1, 2007. Prior to joining the FASB, Mr. Herz was PricewaterhouseCoopers America's Theater Leader of Professional, Technical, Risk & Quality and a member of the firm's Global and U.S. Boards. He also served as a part-time member of the International Accounting Standards Board. Mr. Herz is both a certified public accountant and a chartered accountant.

Among Mr. Herz's other activities, he chaired the AICPA SEC Regulations Committee and the Transnational Auditors Committee of the International Federation of Accountants, and served as a member of the Emerging Issues Task Force, the FASB Financial Instruments Task Force, the American Accounting Association's Financial Accounting Standards Committee, SEC Practice Section Executive Committee of the AICPA, and the International Capital Markets of the New York Stock Exchange.

Lewis H. Ferguson, Partner **Gibson, Dunn & Crutcher LLP**

GIBSON, DUNN & CRUTCHER LLP

Lewis H. Ferguson is a partner in the Washington, D.C. office of Gibson, Dunn & Crutcher LLP and a member of the firm's Securities Regulation and Corporate Transactions practice groups. Mr. Ferguson's practice focuses on the representation of accounting and auditing firms and their employees, securities regulation and disclosure issues and corporate governance matters.

Mr. Ferguson joined the firm in 2007 after serving for more than three years as the first General Counsel of the Public Company Accounting Oversight Board. At the PCAOB, Mr. Ferguson was in charge of all legal affairs and was involved in drafting the PCAOB's rules and regulations and auditing standards, including auditing standards for the audit of internal controls. He also oversaw the successful defense of litigation against the PCAOB challenging the constitutionality of the organization and of the Sarbanes Oxley Act itself. Prior to joining the PCAOB in 2004, Mr. Ferguson was a partner in another Washington, D.C. firm where he specialized in corporate transactions, securities enforcement matters and representation of audit committees and boards of directors.

Fair Value (FV) measurements have been permitted or required for many years in many places.

However, prior to Statement 157:

- FV defined inconsistently
- Measurement approaches inconsistent
- Inadequate disclosures

Recording assets and liabilities acquired in a business combination.

Impairment of financial assets, inventory, long-lived assets.

Stock-based compensation measured at FV on the grant date.

- Note Statement 157 does not apply to stock-based compensation

Asset retirement obligations initially recognized at FV.

Marketable securities

Derivatives

Other financial assets

- FV option under Statement 159

Servicing rights and obligations

- FV option under Statement 156

Proponents argue that fair value:

- Is more relevant and useful
- Properly reflects real-world volatility
- Simplifies financial reporting
- Is more comparable
- Is more understandable

Opponents argue that fair value (particularly in the absence of an actively traded market):

- Is less reliable (more subjective)
- Results in “meaningless” volatility in reported earnings
- Is difficult to reliably measure and audit
- Creates earnings management opportunities
- Creates fear of second guessing from auditors, regulators

Statement 157 does not require any additional fair value measurements.

Statement 157:

- Defines fair value
- Establishes a framework for measuring fair value – three-tier hierarchy
- Enhances fair value disclosures

“Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”

Transaction price = entry price; fair value = exit price

In many transactions, transaction price may be fair value.

Level 1 inputs

- Quoted prices (unadjusted) for identical assets or liabilities in active markets
- PxQ
- Blockage discount prohibited

Level 2 inputs

Observable inputs for:

- Similar assets or liabilities in active markets
- Identical or similar assets or liabilities in inactive markets
- Inputs other than quoted prices that are directly observable (e.g., interest rates, yield curves, default rates)
Example: Interest Rate Swaps
- Inputs derived principally from or corroborated by market data by correlation or other means (market corroborated inputs)
Examples: royalty rates, business valuation multiples, real estate prices per square foot

Level 3 inputs Unobservable inputs:

- Inputs derived through extrapolation or interpolation that cannot be corroborated by market data
- Other entity-specific inputs [historical or projected financial data (revenues, earnings, cash flow, etc.) that are not derived from market data]
- Unobservable inputs shall reflect the reporting entity's own assumptions about the assumptions that market participants would use
- In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions
- The reporting entity shall not ignore information about market participant assumptions that is reasonably available without undue cost and effort
- Examples: intangible assets, private equity investments, certain derivatives

The fair value measurement for each major category of assets and liabilities:

- Re-measured each reporting period (e.g., trading securities)
- Re-measured on non-recurring basis and the reason for re-measurement (e.g., impairment)
- Impact on the balance sheet accounts and reported earnings

Where in fair value hierarchy each measurement falls, separated by each level.

Annually – the valuation technique used for each measurement, and a discussion of changes in techniques, if any.

Effective for financial statements issued for fiscal years beginning after:

- **November 15, 2007**
 - Financial assets and liabilities
 - Non-financial assets and liabilities recognized or disclosed at fair value in the financial statements on a recurring basis
- **November 15, 2008**
 - Non-financial assets and liabilities except for those items that are recognized or disclosed at fair value in the financial statements on a recurring basis
- **The above assumes that the Board approves the proposed FASB Staff Position amending the effective date.**

Act with loyalty to corporation and due care.

This is an objective standard:

- Act in good faith.
- Act in the best interest of corporation.
- Act carefully.
 - Pay attention
 - Ask questions
 - Be informed
 - Seek expert guidance if needed
- Act like a reasonable person with common sense, practical wisdom and informed judgment would act in similar circumstances.

General board responsibility:

- Oversee management of the corporation
- Monitor performance in light of financial plans, strategies and objectives

Audit committee responsibilities for financial reporting:

- Understand company's risk profile and risk monitoring and control programs
- Understand financial statements and monitor adequacy of financial and other internal controls as well as disclosure controls and procedures
- Establish and monitor compliance systems
- Report to board

Recognize that initial application of Fair Value (FV) principles is likely to impose stress at many levels of corporation

Management

Internal auditors

External auditors

Questions that need to be answered:

- Does company have appropriate skilled personnel to apply the F/V Reporting principles?
- Are additional human, IT, or other resources needed to assure compliance?
- Should experts or consultants be hired?
- Is the company's internal audit function capable of dealing with the F/V issues?
- Does the company's external auditor possess the requisite skills to deal with F/V?
- Are the company's financial reporting and disclosure policies and procedures robust enough to deal with what may be an increase in volatility of financial results as a result of F/V Reporting?

For some assets FV reporting is optional not mandatory. Choices are important.

FV Reporting may increase volatility of financial results.

FV Reporting may increase opportunities for subjective valuations and earnings management.

Particular Responsibilities of Audit Committee for Oversight of Financial Statements and Application of FV Principles:

- Select the auditor and approve audit and non-audit services
- Review corporation's annual and quarterly financial statements and management certifications
- Understand corporation's significant accounting policies
- Evaluate quality of management's accounting judgments in preparing financial statements
- Review and evaluate MD&A and financial disclosure processes
- Consult with external auditors concerning audit work plan, results and recommendations
- Consider, in consultation with internal and external auditors, adequacy of internal control systems
- Review management's assessment of effectiveness of internal control
- Meet with management to review risk exposures and discuss risk control strategies

Committee should gain an understanding as to how management applied the FV reporting rules

- Where FV reporting is permissive not mandatory – why did management make a particular choice?
- What are likely financial consequences of the FV reporting choices made by management?
- Do the outside auditors agree with management's choices?
- Which FV measurements are recurring and non-recurring and how were determinations made?
- What are the consequences for the company of FASB's partial deferment of FV implementation?

Audit Committee members do not have to be FV experts but do need to make good faith effort to understand FAS 157 hierarchy and management's choices:

- How were assets classified as Level 1, 2 or 3?
- Who made decisions?
- Were outside experts used? If so, what were their qualifications, and what did they do?
- How were valuation benchmarks chosen, and are any unusual or subject to biases? If so, why?
- Do outside auditors agree with classification and choice of benchmarks, and what procedures did they apply to evaluate?

Absence of market data for level 3 assets makes valuation of some things like private securities, intangibles, and certain derivatives very difficult.

Questions for Audit Committee to consider for level 3 assets:

- Do persons selecting valuation techniques or models have an interest in the outcome? Compensation, corporate resource allocation, career advancement or otherwise?
- What are qualifications of persons making the choices?
- Were outside experts consulted either on technique, model choice or application?
- Did outside auditors review choices? Were there disagreements with outside auditors?

Valuation models can be useful but also pose special risks

- How were models chosen? Were outside experts consulted?
- Does company have personnel sufficiently qualified to choose and operate models?
- What are known weaknesses or biases of particular models? Were those weaknesses or biases considered when choosing models? Were alternatives available?
- How do models operate under market stress – absence of liquidity, or large interest rate movements for example?
- Are models consistently applied by the company?
- What testing of models did outside auditors do?

Derivatives and hedging (Statement 133)

- Does the company use derivatives and if so, for what purposes?
- How does the company account for its derivatives?
 - Mark-to-market through earnings
 - Qualifying hedges
 - How does the company ensure it has met the appropriate hedging criteria?

Derivatives and hedging (cont.)

- What disclosures have been made?
 - In the footnotes?
 - In MD&A?
 - In SEC “market risk” disclosures
- Has the company received any inquiries from the SEC in this area?

Always an area for special scrutiny

Review impact of FV Reporting on related party transactions

Confirm that FV calculations in related party transactions are not being managed for benefit of related persons and to company's detriment

**Have internal and external auditors reviewed these transactions and any FV calculations?
Are there disagreements?**

Recognize that FV accounting can increase volatility of reported financial results

Evaluate with management company's financial, operational and strategic exposure to the credit, liquidity, and valuation issues in the financial markets and the impact of FV reporting

Assist in developing and overseeing the company's plan to address the identified financial, operational, and strategic exposures

Understand the company's disclosure process for FV – talk with management, general counsel, outside counsel

- How is the implementation and impact of FV Reporting described in MD&A and periodic filings?
- Are descriptions accurate and complete?
- Are valuation model risks and limitations disclosed?
- Understand how the company deals with financial volatility resulting from FV Reporting in:
 - press releases
 - company websites
 - conference calls
 - other public and private media

SOX specifically empowers audit committees to retain outside experts at company expense.

Consider using outside experts if committee:

- Has doubts about management expertise in applying FV principles
- A specific problem arises with application of FV principles or reporting of FV results
- Audit committee or board wants a second look at what management is doing in the area of FV Reporting



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