UNCORRECTED PAGE PROOFS
PLEASE DO NOT CIRCULATE
Copyright Harvard Business School Publishing Corporation. All rights reserved.

BY H. DAVID SHERMAN, DENNIS CAREY, AND ROBERT BRUST

The Audit Committee's New Agenda

It's not all about compliance anymore. Board audit teams are refocusing on risk, supporting strategy, and restoring public confidence.

JOIN THE BOARD of directors? Yes. The audit committee? No. That's been the typical response from executives the world over when approached about board service – particularly in the past few years. After all, who in their right mind would want to trade sailing, golf, and exotic travel for the increasingly complex (not to mention high-profile) new world of financial disclosure and reporting? Since the passage of Sarbanes-Oxley (SOX) legislation in 2002, audit team members have had to adapt to new constraints on operating frameworks and committee composition and endure longer and more frequent meetings filled with all manner of compliance minutiae, while putting their own reputations on the line.

It's a vital subset of the board, of course, typically charged with a variety of monitoring functions. These include overseeing the principles and processes by which a company's financials are recorded and disseminated; hiring and monitoring external auditors (that is, public accounting firms); ensuring regulatory compliance; assessing and managing a company's internal financial controls; and reviewing risks with the senior management team.

But the increasingly negative perception of audit committee work, propagated by front-page dissections of vari-

Ryan Snook

4/2/2009 12:25:31 PM

UNCORRECTED PAGE PROOFS
PLEASE DO NOT CIRCULATE
Copyright Harvard Business School Publishing Corporation. All rights reserved.

ous accounting scandals, has made it difficult for businesses to attract the strongest candidates to serve in this corporate capacity. Research suggests that the percentage of new hires to U.S. corporate boards who are experienced CEOs has dropped from 53% in 2000 to under 20% today.

Brilliant, curious individuals are what these groups desperately need – especially now. Generally speaking, audit teams have done the job of incorporating SOX mandates into their practices. Today, their focus is swinging away from basic compliance and back toward increasing the value of the business. Accordingly, they're addressing such challenges as reining in hyperactive M&A decisions, understanding the strategic effects of different accounting methods, and mitigating a spectrum of risks.

In the following pages, we'll describe what the audit committee's new agenda should look like. Our suggestions are based on decades of experience serving on, recruiting, and studying boards and audit teams. While this committee's role and rules may be changing, and the scrutiny still intensifying, one thing remains constant: Its members are the last line of defense when it comes to managing risk and maintaining corporate integrity. They are the final arbiters of the information that appears in shareholder reports. And they have uniquely direct access to all the key players in the C-suite, to critical audit partners, and to other experts. Those executives who answer the call have a great opportunity not just to help ensure the viability of the companies they serve but also to restore public confidence in corporations in general.

IDEA IN BRIEF

- **Now that audit teams are getting a better handle on the intricacies of Sarbanes-Oxley, they can devote precious meeting time to broader agenda items.**
- **These include exerting control over hyperactive M&A decisions, understanding the strategic effects of different accounting methods, and monitoring a spectrum of new risks.**
- **Executives who answer the call have a great opportunity not just to help ensure the viability of the companies they serve but also to restore public confidence in corporations in general.**

The SOX Effect

The Sarbanes-Oxley Act of 2002 was designed to protect investors' interests by reforming accounting practices in large public companies. Many of its advocates pointed to the rise in stock market indexes from 2002 through 2006 as a sure sign of the legislation's effectiveness. But what would they say today, as the same indexes slip well below 2001 levels? Indeed, SOX has ended up raising as many issues as it addressed.

Consider that each year, large public companies in the United States continue to spend in the tens of millions of dollars on compliance. The high costs and added regulations imposed by SOX are two reasons why there's been such a drop in the number of initial public offerings in the United States – and why more and more of that IPO activity is being diverted to European stock markets. In 2005, for the first time, IPO volume on the London Stock Exchange exceeded that on the New York Stock Exchange, by about 20%.

Until recently boards – and audit committees in particular – were spending disproportionate amounts of time on compliance relative to strategy and other matters. One audit team chair told us that immediately after SOX compliance became a critical issue, the group's meetings expanded to eight hours, but its discussion of strategic concerns was reduced to one.

Today, though, that team's meetings last about four hours, and its discussion is now dominated by strategic concerns. That's because this audit committee, like most, has generally made it over the steepest part of the learning curve, altering its practices, information systems, and policies to meet the demands of Sarbanes-Oxley.

Now that audit teams have endured and mastered the onerous drudgery of public company compliance, they can (and need to) move on to more critical, and more interesting, business issues – namely, restoring strategy, business development, and risk management to their proper places at the top of the agenda.

New Minds, New Priorities

As the audit committee's priorities change, its composition will have to reflect the shift. Members will still need extensive experience with financial controls and accounting, of course, but the team will also benefit from different voices, skills, and experience from a range of industries and functions – the very people and talents that Sarbanes-Oxley may have helped drive away. If you're a CEO or CFO who is perhaps considering joining an audit committee, here's why it needs you, particularly now.

Someone needs to reliably decipher financial guesstimates. This issue has to be at the top of a revitalized audit team's agenda, for somewhat obvious reasons. The audit committee's first priority should be to make sure financial projections are sound. To do that, it needs to examine the host of assumptions underlying the measures companies use to estimate income and earnings, many of which are based on management's, outside auditors', and other experts' assumptions and agendas – some clearly outlined and others not so transparent.

Things might have gone differently, for instance, for General Motors last winter had its audit committee been able to do this back in 2006. In the second quarter, GM reported a loss of more than $3 billion and simultaneously issued a report stipulating that onetime adjustments would transform this loss into a profit of about $1 billion (using a pro forma earnings measurement that management had developed to shed light on the "true" financial picture of the company).

191 4/2/2009 12:25:31 PM

UNCORRECTED PAGE PROOFS
PLEASE DO NOT CIRCULATE
Copyright Harvard Business School Publishing Corporation. All rights reserved.

This $4 billion adjustment contained a substantial number of estimates and assumptions about operating profits, none of which were disclosed in the company's SEC filings. So did company executives paint the correct financial picture, or were they just trying to boost shareholder confidence at the expense of some accuracy? We would not begin to speculate. The point is, that's now the kind of question the audit committee should be raising. There are still plenty of opportunities. In 2008, for example, GM's management turned a net loss of $30.8 billion into a pro forma loss of only $16.8 billion. Why was that? It is the responsibility of the audit committee to know and concur, or not.

The audit team's role as the gatekeeper of shareholder communications has always been critical, but perhaps never more so than during these times of economic turmoil. In the wake of the recent revaluation of mortgage-backed securities and collateralized debt obligations, Merrill Lynch initially reported a write-down in value of $7.9 billion for the third quarter of fiscal 2007. This was notably higher than the company's earlier estimates of $4.5 billion in write-downs. What's more, Merrill Lynch reported an additional write-down of $11.5 billion the following quarter.

What do these figures signify? Was the original $4.5 billion estimate the low end of a range? Was the subsequent $7.9 billion the higher end? Was the additional $11.5 billion a result of deteriorating market conditions, poor forecasting, or biased estimates?

Before any such information is released to the public, the audit committee needs to probe the range and timing of significant write-downs and impairments like these and evaluate the wisdom of selecting the amounts stated rather than any other possibilities – and even whether it would be better to offer a range to shareholders at the outset, rather than keep changing the estimates from quarter to quarter.

The committee should ask itself, What would the implications be if a subse-

Beyond Sarbanes-Oxley: The Road Ahead for Audit Committees

It's time for audit committees to turn their attention to a new, far wider – and arguably far more exciting – range of responsibilities. Here is a systematic series of questions you can use to guide you in creating your new agenda.

Judging the accuracy of financial guesstimates

- Should estimates of financial performance be presented to the public as ranges (rather than as single-point predictions)?
- Do pro forma adjusted (non-GAAP) earnings seem accurate when compared with past performance and competitors' reports?
- Is the pro forma earnings presentation warranted? Is it superior to the adjustments that will be made by savvy security analysts and bond raters?
- Are these financial estimates distorted by any hidden agendas management may have involving meeting short-term goals, avoiding takeovers, or bolstering the case to trim key business segments?
- If estimates have been restated, are we prepared to restate non-GAAP measures as well?
- Is our impairment test devoid of influences by managers whose compensation could be diminished if impairments were recognized?

Testing the merits of structured acquisitions' earnings

- Is the structure of the acquisition consistent with the reporting strategy of the business?
- Are we aware of the range, and implications, of management's estimates of the acquired business's future earnings and the fair values assigned to its assets?
- Why are the judgments management has made considered to be the best ones that could have been made?

Defining the scope of risk management

- Have all critical business, financial, and security risks been reviewed by the audit committee?
- Which areas of exposure require immediate or near-term improvement?

Analyzing the implications of competitors' performance

- Do we know how our business's performance compares with that of key competitors around the world?
- Why are management's accounting choices different from those of competitors?
- What are the implications of those differences for the company's reported financial performance?
- Is the compensation committee aware of accounting differences between our business and competitors?
- Do our compensation consultants understand the implications of the different accounting methods (GAAP versus IFRS) our competitors use?

Ensuring the reliability of audit committee oversight

- What are the critical accounting estimates we're using to present an accurate picture of the company's financial performance?
- Are they the ones disclosed in the SEC reports?
- Where the business owns significant assets or generates substantial revenues abroad, have we evaluated the capabilities of the corresponding local audit teams?

UNCORRECTED PAGE PROOFS
PLEASE DO NOT CIRCULATE
Copyright Harvard Business School Publishing Corporation. All rights reserved.

Tapping the right expertise

- Have we allowed ourselves to identify our blind spots, and have we made sure that we have obtained adequate advice in those areas?
- Do we have at least two financial experts among our ranks, one of whom is currently grappling with new reporting and technical developments in his or her own business?
- When will our financial experts need to be conversant in IFRS?
- Should we hire an independent auditor or adviser to offer a second opinion on any matters?

Maintaining rapport with the compensation committee

- What is the relationship between the audit and compensation committees, and has that been reviewed and updated?
- Does the compensation committee understand the implications of the full range of possible financial results represented in the reported earnings well enough to evaluate the impact on their recommendations?
- Should a financial expert from the audit committee also serve on the compensation committee?
- Are the recommendations of the compensation committee's consultants based on performance measures published in shareholder reports, and if so, have they been adjusted for differences in competitors' reporting methods and guesstimates?

quent audit determines that the amount should be much higher or lower? Some have speculated that Merrill Lynch selected the top end of its estimated write-down range, when it moved from the $4.5 billion to the $7.9 billion figure, to enhance future earnings. Others say the company initially selected the low-end $4.5 billion figure to maximize the perceived market value of its equity. In either case, the audit committee was in the best position to evaluate these judgments on behalf of shareholders by examining management's analysis, internal audit reports, and external auditor findings, and when necessary even bringing in an independent adviser.

Someone needs to keep an eye on the "structure" in structured acquisition earnings. Studies show that about half of mergers and acquisitions fail to add value to the parent company because the prices paid in these deals are excessive. Why does this keep happening? These days, the senior management team incorporates estimates of the "fair market value" of the assets and liabilities purchased into its reporting of acquisitions. That certainly gives managers who are so inclined opportunities to "manage" the presentation of earnings to shareholders in ways that will show results in the most optimistic light.

Specifically, earnings statements and balance sheets are structured to include (or exclude) things like the estimated value of R&D, customer lists, capital assets, trademarks, and patents. Management also has discretion when it comes to the timing of bonuses and other merger-related expenses. The range of reported earnings and growth estimates of the resulting merger can be dramatic, depending on how the original value of the acquisition was presented. The audit committee is the only group that can, if it chooses, objectively determine whether management's decisions are built on an artificial picture of growth or are otherwise flawed.

To do so, the committee should ask a series of questions: Where in the wide range of reporting choices that management has made is the accurate picture of the value of the acquisition? What assumptions were managers using to make these estimates? Why was management's choice of accounting options preferred over other approaches? How much of the future performance of the venture has been built into this set of assumptions?

As time goes by and the results become clear, the audit committee should stay on the case, asking: Are reported results consistent with the intended impact of the acquisition? Does the compensation committee understand the implications of management's original choices on its evaluations of executive performance? Did, for instance, the senior management team project an unwarranted earnings stream to ensure its members' bonuses?

Someone has to objectively analyze the myriad risks facing businesses today. Imagine how different the current climate might be if Merrill Lynch, Lehman Brothers, and other financial institutions had decided years ago to limit their investments in mortgage-backed securities or if AIG had decided not to issue insurance in the form of credit default swaps. Risk management has always been a critical task of the audit committee, so this is not a new agenda item. But for many years now, the committee's attention has been trained on only a particular area of risk – compliance with SOX regulations. Even those audit teams that continued to make risk management a priority during the SOX era often found themselves hampered by a lack of wider risk management expertise.

Even after clearing the SOX hurdle, audit committee members still have limited time and attention with which to conduct in-depth risk analysis. So they must carefully target the most important risk categories. Financial and technology risks clearly must be under the committee's purview. Performance assessments (whether the company is achieving expected returns) should be, as well. But – depending on their rele-

193 4/2/2009 12:25:32 PM

UNCORRECTED PAGE PROOFS
PLEASE DO NOT CIRCULATE
Copyright Harvard Business School Publishing Corporation. All rights reserved.

vance to the particular industry or country – strategy, product, legal, and other risks may or may not rise to a level that would warrant regular supervision by the audit committee in particular.

It should go without saying, of course, that in those categories the audit committee does address, the team should conduct a thorough review of all possible associated risks. Then as an ongoing practice, the chairperson should be prepared to lead discussions with the following issues in mind:

Business development, reputational, and operational risk. Are the benefits intended from the organization's investments materializing as planned? If not, why not? A strategy-focused audit committee could have helped any number of financial services firms vet the risks inherent in expanding their products and services to include such infamous toxic assets as collateralized debt obligations and their underlying mortgage-backed securities. The audit team can help management think through risks involved in the development and marketing of a host of new products – from the relatively mundane (vitamin-enhanced bottled water) to the exotic or revolutionary (a car that can sell for less than $3,000 or an electronic device for downloading and reading books).

Financial risk. What are the critical areas of exposure when it comes to currency, interest rates, and commodity input prices? To answer this question, reliable experts who understand each of these areas should provide assessments, in a comprehensible way, directly to the audit committee. (This may require three separate expert advisers.) Is the disclosure to shareholders understandable? (Try reading the market risk section of your annual 10-K report and consider whether it tells the full story.) Does the audit committee understand and agree with management's initiatives for mitigating financial risks? For instance, numerous financial institutions and financing divisions of major companies – think Fannie Mae, Bank of America, GE Capital, and Ford – have used interest rate swaps, a derivative designed to minimize the impact of fluctuations in interest rates. And as a result, many such financial institutions have filed restatements. Technically, in accounting for these swaps, these companies may have violated accounting rules. But the situation is not black-and-white. Often, these violations are not serious enough to threaten the economic soundness of the business. In fact, using this type of derivative to reduce risk is generally considered good management practice. The point is, it needs to be the audit team's responsibility to understand, and sign off (or not), on management's approach, because the committee is uniquely situated to distinguish economic risk from technical accounting issues and to ensure that this understanding is communicated to shareholders.

> Before 2000, you could hardly find 50 restatements a year. Between 2005 and 2007, more than 3,000 were filed.

Data risk. When you consider the credit information breaches at TJX and other companies, it's clear that IT has to be a critical piece of the audit committee's risk analysis. (A few small businesses delegate oversight of this risk category to a separate committee, but that's generally the exception rather than the rule.)

To oversee this risk, audit committees need to ask: What plans are in place to protect critical databases and other information systems from terrorist attacks, pandemics, and natural disasters? Answering that question may involve some independent verification, since company executives may not know the true state of their data security.

One audit committee member we spoke with recalled a session in which senior management's data protection efforts were described in detail to the committee. Members were assured that entry codes were required for all basic systems, that password distribution was limited, and that passwords were not saved or embedded in the information systems. But the very next day, at the full board meeting, someone from one of the departments opened up a data file, and in plain view of the committee the system automatically filled in the stored password – vividly demonstrating how poorly implemented the plans really were.

International risk. When it comes to international transactions, the audit committee can defer some recurring issues to the full board – for instance, complying with local regulations and protecting some intellectual and physical assets. There are times, however, when the risks are so great that they become part of the committee's responsibility for the fidelity of company financial reporting. Blockbuster, for instance, had to close stores in Hong Kong in 2004 and Spain in 2006 because competition from bootleg videos was so intense it rendered the retail operations unviable. When international risks threaten to rise to that level, it's incumbent upon audit committees to take a close look at cultural norms, the role of bribes, local laws, and so on. It may not be feasible for businesses to avoid countries where counterfeit trade is widespread, such as China, Russia, Brazil, and India, since they also represent some of the most attractive markets. Here's where a revitalized audit committee, no longer distracted by SOX compliance, can take a strong hand in evaluating risks and suggesting precautionary measures to minimize the cost of intellectual property theft while maintaining access to valuable markets.

Related-party transactions represent another significant, continuing, and un-

194 4/2/2009 12:25:32 PM

UNCORRECTED PAGE PROOFS
PLEASE DO NOT CIRCULATE
Copyright Harvard Business School Publishing Corporation. All rights reserved.

derappreciated risk of doing business in many different cultures and business environments. Post-SOX practices requiring financial managers and sales representatives around the world to sign statements stipulating that there exist no side letters or other conflicts of interest are simply not enough and can create a false sense of security. If there were a sure remedy for this pervasive issue, businesses would already have implemented it. In the meantime, management needs to be vigilant in its monitoring of related-party transactions, and the audit committee needs to be equally vigilant in its oversight of management's monitoring efforts.

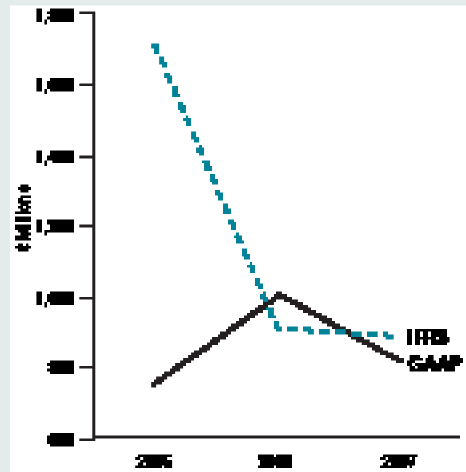
Someone has to accurately assess rivals' performance worldwide. All public companies and many private businesses in the 27 European Union countries have adopted International Financial Reporting Standards (IFRS), the dominant alternative to the Generally Accepted Accounting Principles (GAAP), and others outside the EU are in the process of doing so. U.S. businesses that want to meaningfully evaluate their performance against global competitors, which are likely to be using IFRS, will therefore need to understand the differences between these reporting approaches. (See the sidebar "A Tale of Two Accounting Standards.")

Air France offers one example of the dramatic differences that can exist between IFRS and GAAP earnings, equity, and other critical performance ratios. As the exhibit "The Difference Accounting Standards Can Make" shows, the net income figures using GAAP versus IFRS were quite far apart in 2005 and yet were much closer together in 2006. What's more, the GAAP report suggests a decline in the next year, whereas the IFRS accounting shows a more modest, almost flat, earnings trend.

IFRS is likely to become the required set of accounting principles in the United States, replacing GAAP as early as 2014. Still, comparisons of financial statements will always need to take into account differences in standards, since various countries have adopted IFRS with their own modifications. Meanwhile, even competitors that use GAAP may make different accounting choices within the framework. Consider that over a 10-year period, Delta increased the depreciable life of its aircraft twice – from 15 to 20 years the first time and then from 20 to 25 years. It's now using 30 years, as the company emerges from bankruptcy reorganization. Each year's depreciation charge, therefore, went down accordingly, boosting stated earnings. Other airlines did not make this change. So if you were on the audit committee of Singapore Airlines, which uses a 15-year depreciable life, you would probably want to know why management believes that a shorter depreciation schedule is more appropriate. You might want to disclose this logic to shareholders and perhaps eliminate the accounting differences related to depreciation where they artificially over- or understate relative earnings and performance.

The Difference Accounting Standards Can Make

How much did Air France earn in net income from 2005 through 2007? The answer is radically different depending on whether it's determined using Generally Accepted Accounting Principles or the International Financial Reporting Standards:



Inside the Boardroom

Audit committee members are not just concerned with keeping their organization on the straight and narrow and fulfilling their responsibilities to shareholders. They are also concerned, of course, with preserving their own reputations. After all, no one looks good when problems arise that the audit team should have recognized in early stages or when the committee is found to have relied on inaccurate information from senior managers, external auditors, or other experts. With that end in mind, here are several additional items that also need to be high on the committee's agenda.

Audit reliability. Before 2000, you could hardly find 50 corporate restatements a year. Between 2005 and 2007, more than 3,000 revised earnings statements were filed – powerful evidence of the need for a renewed focus on reliability within the audit process.

Accounting debacles in the United States have received a lot of attention and scrutiny, but plenty of them are unfolding in other countries as well. In one case, UK-based Allied Carpets was forced to restate its earnings when it was found to be recording revenues prematurely. The stock price nose-dived, executives were fired, and a round of news articles couldn't resist reporting that the company was in a "deep pile of trouble" and "not as good at solving problems as sweeping them under the carpet."

Any number of U.S.-based businesses have had problems with their Asian and European operations that were not identified by international auditing firms' local offices. These problems are often due to the complexity (many would say the excessive complexity) and differing interpretations of GAAP by different auditors (sometimes in the same company), so this is not a problem that audit committees can directly fix,

195 4/2/2009 12:25:32 PM

UNCORRECTED PAGE PROOFS
PLEASE DO NOT CIRCULATE
Copyright Harvard Business School Publishing Corporation. All rights reserved.

since they don't oversee the audit industry. Instead, the group needs to concentrate on protecting shareholders from misleading accounting and outright fraud. The audit team and its partners won't be able to eliminate all criminal activity, obviously, but oversight that is squarely focused on shareholders' interests can help limit some of the losses, as well as preserve committee members' reputations.

In this effort, the audit team should get help. A prominent SEC lawyer speaking to corporate counsels and secretaries several years ago at a meeting of the U.S. National Association of Corporate Directors predicted that, by the end of this decade, it would become common practice for audit committees to employ independent advisers.

This is essentially the way GAAP accounting violations were identified at Fannie Mae. The Office of Federal Housing Enterprise Oversight, which oversees Fannie Mae, hired a second Big Four global-accounting firm to evaluate how derivatives had for years been represented as GAAP compliant by Fannie Mae's external auditors. This second opinion reported technical GAAP violations. The SEC was asked to review the arguments of the two accounting firms to determine whether Fannie Mae was or was not in compliance. The SEC concluded that it was not, in effect agreeing with the second opinion. This triggered a restatement, as well as a replacement of management (and of several audit committee members). The cost of getting a second opinion may have seemed excessive to some – but not as exorbitant as the more than $1 billion it reportedly cost Fannie Mae to fix the problems, implement new information systems, and re-audit and restate several years' worth of financial statements.

Expertise. Single-handedly keeping up with the volume and breadth of issues involved in shareholder reporting is probably beyond the ability of even the most expert accountant or financial analyst. Fannie Mae's audit committee had two financial experts, and even so no one cottoned on to accounting irregularities that had been going on for years.

Satyam Computer Services, an IT outsourcer based in India, recently announced that its CEO was allegedly involved in a multiyear fraud having to do with an overstatement of the amount of cash in the business and substantial payments to nonexistent employees. The audit committee, which did not identify any member as a financial expert, has since come under significant scrutiny: Did its members have the background to evaluate and protect assets, judge the qualifications of internal and external auditors, and inquire into the scope of work done by these auditors?

If there is only one financial expert on the audit committee, that individual is likely to bear most of the burden of assessing new or existing accounting policies. Other board members, generally appointed for different areas of expertise like industry, political, or functional intelligence, are likely to find technical financial-reporting issues less interesting. If there were a problem with, say, derivatives accounting, where the basic guidelines exceed 800 pages, would the nonfinancial experts invest the time needed to seriously evaluate the business's activities? Not likely. They would naturally defer to the financial expert and would not be able to contribute to any analysis or otherwise take responsibility for the problem. On one audit team, reporting requirements regarding tax estimates had a numbing effect

A Tale of Two Accounting Standards

ALL MAJOR INDUSTRIAL countries have converted to or are planning to adopt the International Financial Reporting Standards. The European Union has been using IFRS since 2005, and so have South Africa and Australia. The United States is the only country that exclusively uses the Generally Accepted Accounting Principles (GAAP) for public company reports. But even U.S. corporations may be required by the Securities and Exchange Commission to convert to IFRS within the next five years.

Until a single accounting system is adopted internationally, U.S. companies using GAAP will be reporting earnings and balance sheet values differently from their competitors outside the States. If financial statements are being used to compare corporate performance, establish executive compensation, or estimate the value of an acquisition target, they will need to be adjusted to account for differences in the reporting standards. Otherwise, boards and managers can come to misleading, and possibly quite costly, conclusions.

The differences between IFRS and GAAP are numerous. Some are straightforward and easy to accommodate. For instance, both IFRS and GAAP require auditors to write down inventory if its market value declines below what the company paid for it. Under IFRS, the inventory value could also be written back up to the higher initial figure if its market value increases, whereas GAAP does not allow that. As another example, IFRS doesn't let companies segregate onetime events from normal income and designate them as extraordinary, as the GAAP income statement does. That means a company's losses stemming from, say, the attacks of September 11, 2001, are included in the regular income statement under IFRS rules.

Other differences are much more difficult to identify. The two systems differ, for example, in their underlying philosophies about how to measure revenues and expenses. GAAP is a rule-based system (based on principles); very specific accounting guidelines govern the entire range of business transactions. By contrast,

UNCORRECTED PAGE PROOFS
PLEASE DO NOT CIRCULATE
Copyright Harvard Business School Publishing Corporation. All rights reserved.

on some of the nonfinancial members. Stock option valuation, derivatives, cash flow classifications, and asset valuations evoke similar reactions. Even the financial experts that come out of investment banking, lending, or technology businesses can find some of these discussion points distant, unfamiliar, and tedious. Conversely, audit committee members who come from professional backgrounds – former partners in CPA firms, investment managers, and securities analysts – may have a myopic focus or insufficient expertise in some broader financial areas that may become critical.

That's why it's so important that there be at least two financial experts on the audit committee to share the burden and to offer a broader set of technical expertise. One of these can be a seasoned retired executive, but the other should be someone who is still grappling with new reporting and technical developments in his or her own business. And for global corporations, one should be conversant in IFRS as well as GAAP. Above all, these committee members need to be willing to recognize their blind spots and access additional independent technical advice to complement their expertise.

Rapport with the compensation committee. Because of the streams of data and the leaders it has access to, the audit committee is in the perfect position to judge whether the facts and figures used in the compensation committee's performance analyses are correct and whether the budgets used to set management targets and bonuses are fair. To be most constructive, the committee should ask: Is the compensation group aware of the judgments underlying the company's reported earnings and of possible alternative ways to calculate them? Does it have this information in a format that will allow it to factor these judgments into its own recommendations? Expanded SEC disclosure requirements for individual executives and highly compensated employees will increase the need for the audit and compensation committees to jointly evaluate performance. Furthermore, the audit team will need to reassess and revise compensation-reporting practices as those requirements are clarified over the next few years. So it's essential to assign one of the audit committee's financial experts to serve on the compensation committee as well.

• • •

The audit committee is uniquely suited to assess risk, judge the valuation and results of mergers and acquisitions, and ensure that company strategy and finances are aligned. All the accounting scandals of the past decade and Sarbanes-Oxley are in its rearview mirror, so to speak. It's time for this committee to assert its unique role as messenger to the rest of the board of directors on all matters of risk management and financial-reporting judgments and to bolster trust among corporate constituencies – especially shareholders.

IFRS is a principle-based system (with far fewer rules than GAAP); management and auditors are given leeway to consider what constitutes a fair representation of revenues and expenses within a broad set of guidelines.

Say a company sells software with guaranteed future upgrades, and the value of the upgrades is not yet known. GAAP standards mandate that no revenue at all be recorded in the income statement until the upgrades are developed and provided to the customer or until the cost and value of the upgrades are known and verifiable. Under IFRS, though, senior managers could make an educated estimate of the cost and value of the upgrades based on historical or other evidence, and they could then record revenues directly resulting from the initial product while deferring revenues related to future upgrades. Consequently, although total revenues would ultimately be the same in both systems, GAAP revenues would be lower than IFRS revenues in the initial accounting period and then higher in the period when the upgrades were delivered. This raises the question, If the business will appear less favorable under GAAP than IFRS in the short term, should it voluntarily provide an estimate of IFRS earnings, revenues, assets, and liabilities as well?

Two background issues are likely to affect the relative use and usefulness of these two reporting standards for U.S. companies. First, one of the strongest arguments for using GAAP is that it has been tested and subjected to extensive scrutiny and interpretation in the U.S. legal system. By contrast, disputes involving IFRS-based shareholder reports may have to establish new legal precedents—with all the uncertainty and higher litigation costs that come with them. Second, different companies and their auditors can apply IFRS standards differently, making it difficult to compare one company with another or judge the quality of audits. What's more, if you're joining an audit committee that uses IFRS, you can expect to see more and expanded footnotes—and you'll shoulder increased liability for the content of those footnotes.

H. David Sherman *(h.sherman@neu.edu) is a professor of accounting at Northeastern University in Boston, the Principal Adviser on IFRS to CCH, and a coauthor of "Tread Lightly Through These Accounting Minefields" (HBR July–August 2001).* **Dennis Carey** *is a senior partner at Korn/Ferry International in Philadelphia and a coauthor of* CEO Succession *(Oxford University Press, 2000).* **Robert Brust** *is the chief financial officer at Sprint in Overland Park, Kansas.*

Reprint R0906k
To order, see page xxx.

UNCORRECTED PAGE PROOFS
PLEASE DO NOT CIRCULATE
Copyright Harvard Business School Publishing Corporation. All rights reserved.

UNCORRECTED PAGE PROOFS
PLEASE DO NOT CIRCULATE
Copyright Harvard Business School Publishing Corporation. All rights reserved.