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Heads Up

Audit and Enterprise Risk Services

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In This Issue:

Sleigh Bells Ring — Are You Listening?

Highlights of the 2007 AICPA National Conference on Current SEC and PCAOB Developments

by Deloitte & Touche LLP's National Office Departments of Professional Practice

Introduction

Shortly before the holidays, the AICPA holds its annual National Conference on Current SEC and PCAOB Developments. During the conference, the SEC, PCAOB, FASB, IASB, and other standard setters provide financial professionals with updates on new developments, regulations, and current priorities — just in time for the annual reporting season.

This issue of *Heads Up* extracts key insights from nearly 26 hours of material. Besides links, we haven't included information widely available elsewhere — for example, details on new or proposed accounting guidance are on the FASB's Web site at www.fasb.org. Instead, this *Heads Up* focuses on experts' unique viewpoints on topics ranging from accounting and disclosure issues stemming from troubled credit markets to SEC Chairman Christopher Cox's intention (announced at a concurrent meeting) to propose a further one-year delay, for nonaccelerated filers, of the requirement that auditors attest to internal control over financial reporting.[1]

To locate the topics that interest you, use the topical index in Appendix B or the tables below (one each for Keynote Speakers, U.S. Accounting Principles, SEC Matters, Internal Control Over Financial Reporting and Other Auditing Matters, and International Financial Reporting). Then, click a speaker's name to jump to a speech summary.

Conference Themes

The recurring theme at this year's conference? Again and again, standard setters and regulators pointed to current and future steps that might ultimately lead to global use of a single set of accounting standards. SEC Commissioner Kathleen Casey stated that the "incontrovertible fact is that IFRS is gaining worldwide acceptance at a rapid pace. Over 100 countries have or are in the process of adopting IFRS. . . . As IFRS continues to expand worldwide, it is critical that the Commission be involved in decision making for the future." With much of the world on a path toward IFRSs, the possibility of U.S. acceptance of IFRSs and the demand for global comparability become key. SEC Chief Accountant Conrad Hewitt

[1] See Chairman Cox's testimony "Sarbanes-Oxley Section 404: New Evidence on the Cost for Small Companies" before the U.S. House of Representatives Committee on Small Business.

noted that in "all of the Commission's work to date, a consistent premise has been that investors are better served by having available high quality financial information across issuers, regardless of their domicile. This aids investors in making informed decisions in allocating their capital among competing alternatives."

The SEC recently voted to eliminate its requirement that foreign private issuers reconcile, to U.S. GAAP, financial statements prepared in accordance with IFRSs as published by the IASB. Mr. Hewitt commended the decision as a significant step toward a single set of global accounting standards. The SEC's related concept release — potentially giving U.S. companies the option to prepare IFRS-based financial statements — is still being considered. Many speakers supported this option, although some were concerned about the possibility of increased complexity and uncertainty during transition. For example, FASB Chairman Robert Herz warned against adopting IFRSs without a blueprint that includes steps such as (1) ensuring appropriate IASB governance, funding, and staffing; (2) ensuring that IFRSs are of sufficient quality for adoption; and (3) avoiding IFRSs taking on a U.S. "national flavor."

Many speakers took aim at the complexity of U.S. financial reporting. Robert Pozen, chairman of the SEC's Committee on Improvements to Financial Reporting (CIFiR), covered the CIFiR's goals and offered his preliminary views on reducing complexity in financial reporting and in the profession. The CIFiR has cited "guidance," often articulated in SEC speeches, as a factor contributing to the increase in restatements. Dovetailing with this concern, Chief Accountant Hewitt expressly indicated that his remarks did not constitute new GAAP, and his deputy, James Kroeker, warned against considering the SEC staff's remarks as authoritative guidance.

The turmoil in the financial markets was another theme at this year's conference. Speakers shared their views on valuation and disclosure issues.

XBRL and the need for and acceptance of professional judgment were two other themes, carried over from previous conferences. The SEC staff recently issued a U.S. GAAP XBRL data tagging system (taxonomy) for public comment. The staff pointed out the low cost of implementing XBRL as well as the substantial benefits it provides to financial statement users.

Speakers and Topics

To see details, turn to the speech summaries or click a speaker's name below. Links to additional reference materials appear throughout the speech summaries.

KEYNOTE SPEAKERS		
Speaker	**Topics Covered**	**Affects**
Kathleen L. Casey, *Commissioner*, Securities and Exchange Commission Randy G. Fletchall, *Chairman*, American Institute of Certified Public Accountants Conrad W. Hewitt, *Chief Accountant*, Securities and Exchange Commission	• Convergence and the use of IFRSs • Complexity, professional judgment, and the role of the CIFiR • The SEC's actions on the current state of the financial markets • XBRL • Auditor independence	Preparers, auditors, regulators, and users of financial statements
Cynthia M. Fornelli, *Executive Director*, Center for Audit Quality	• Center for Audit Quality's mission, members, and activities	Preparers, auditors, regulators, and users of financial statements
Robert H. Herz, *Chairman*, Financial Accounting Standards Board	• Global financial reporting	Preparers, auditors, regulators, and users of financial statements

[2] The full title of each standard referenced in the *Heads Up* appears in Appendix A: Glossary of Standards.

Mark W. Olson, *Chairman*, Public Company Accounting Oversight Board Thomas Ray, *Chief Auditor and Director of Professional Standards,* Public Company Accounting Oversight Board	• International developments • Auditing Standard 5[2] • Audit report date • Inspections and enforcement • Auditing fair value measurements • Standard-setting priorities	SEC registrants and auditors of public companies
U.S. ACCOUNTING PRINCIPLES		
Speaker	**Topics Covered**	**Affects**
Mark J. Barrysmith, *Professional Accounting Fellow*, Office of the Chief Accountant of the Securities and Exchange Commission	• Market instruments used to measure fair value of share-based payments • Revenue recognition: whether joint steering committee participation is a “deliverable” • Product and service revenue presentation	Entities that grant employee share-based payment awards Entities party to multiple-element revenue arrangements that include steering committees Entities with multiple-element revenue arrangements involving both products and services
Mark J. Barrysmith, *Professional Accounting Fellow,* Office of the Chief Accountant of the Securities and Exchange Commission Ashley W. Carpenter, *Professional Accounting Fellow*, Office of the Chief Accountant of the Securities and Exchange Commission Michael D. Foley, *Partner*, KPMG LLP Russell Hodge, *Global Controller — Center of Excellence*, General Electric Paul Munter, *Partner*, KPMG LLP Brian Stevens, *Practice Fellow*, Financial Accounting Standards Board	• Impact of market illiquidity on fair value measurements and the role of the Center for Audit Quality • Debt and equity issues • Interpretation 48 issues	Entities with certain illiquid investments (e.g., subprime mortgage loans) Entities that issue convertibles or other financial instruments settled in their own shares (other than share-based payments to employees) Entities with uncertain tax positions
Ashley W. Carpenter, *Professional Accounting Fellow*, Office of the Chief Accountant of the Securities and Exchange Commission	• Classification of loan receivables • Other-than-temporary impairment of securities • Initial adoption of Statement 159 • Accounting for equity derivatives	Entities with loan receivables balances Entities holding debt and equity securities Entities with held-to-maturity and available-for-sale securities at adoption of Statement 159 Entities with equity derivatives

Allan Cohen, *Assistant Controller*, Time Warner Jan R. Hauser, *Partner*, PricewaterhouseCoopers LLP Stefanie Tamulis, *Project Manager*, Financial Accounting Standards Board	• Statements 141(R) and 160	Companies consummating business combinations and companies with noncontrolling interests
G. Michael Crooch, *Vice-Chairman*, Financial Accounting Standards Board Russell G. Golden, *Director of Technical Application and Implementation Activities*, Financial Accounting Standards Board Tom Hoey, *Director of the FASB Codification Project*, Financial Accounting Standards Board Richard R. Petersen, *Managing Director*, Financial Reporting Advisors, LLC	• AcSEC activities • FASB initiatives • FASB projects (including joint projects with the IASB) • EITF activities • FASB codification project	Preparers, auditors, regulators, and users of financial statements
Greg Franceschi, *Managing Director,* Duff & Phelps Chester Spatt, *Mellon Bank Professor of Finance*, Tepper School of Business at Carnegie Mellon University Michael Tully, *Practice Fellow*, Financial Accounting Standards Board	• Fair value measurements • FASB Valuation Resource Group • Defensive value • Valuation models	Entities with assets and liabilities measured at fair value
Stephanie L. Hunsaker, *Associate Chief Accountant*, Division of Corporation Finance of the Securities and Exchange Commission	• Presentation of a change from consolidation to equity method accounting • Management's Discussion and Analysis in the current credit environment	Entities with investments in subsidiaries Registrants with exposure to the conditions of the current credit market

Sandie E. Kim, *Professional Accounting Fellow*, Office of the Chief Accountant of the Securities and Exchange Commission	• Revenue recognition for hardware deliverables in software arrangements
	• Fair value
	  • Intangible assets and the use of a replacement cost approach
	  • Discounts and share-based payment arrangements
	  • Interaction of the fair value option with nonfinancial performance obligations
	  • Simplified method of calculating expected term for share options
		Entities that enter into arrangements within the scope of SOP 97-2 that contain hardware deliverables
		Entities that value intangible assets
		Entities that issue share-based payment arrangements
		Entities electing the fair value option
		Entities that issue share options

James L. Kroeker, *Deputy Chief Accountant*, Office of the Chief Accountant of the Securities and Exchange Commission	• Confidence in making accounting decisions • Authority of SEC staff remarks • Subprime loan developments	Preparers and auditors of financial statements Lenders with on-balance-sheet subprime loans or loan servicers of subprime loans sold to qualifying special-purpose entities
Robert C. Pozen, *Committee Chairman*, Securities and Exchange Commission Advisory Committee on Improvements to Financial Reporting	• Update on activities of the SEC's Advisory Committee on Improvements to Financial Reporting (CIFiR)	Preparers, auditors, regulators, and users of financial statements
Eric C. West, *Associate Chief Accountant*, Office of the Chief Accountant of the Securities and Exchange Commission	• Accounting for litigation settlements • Interpretation 45 guarantees in a spin-off transaction • Determining the acquirer in a business combination under Statement 141	Companies involved with litigation settlements Parent companies and subsidiaries that retain guarantees after a spin-off Companies that acquire businesses
	SEC MATTERS	
Speaker	**Topics Covered**	**Affects**
Wayne E. Carnall, *Chief Accountant*, Division of Corporation Finance of the Securities and Exchange Commission Craig C. Olinger, *Deputy Chief Accountant*, Division of Corporation Finance of the Securities and Exchange Commission	• Goals and objectives for the Division of Corporation Finance • Filing review statistics	SEC registrants
Linda Chatman Thomsen, *Director*, Division of Enforcement of the Securities and Exchange Commission Susan G. Markel, *Chief Accountant*, Division of Enforcement of the Securities and Exchange Commission Walter G. Ricciardi, *Deputy Director*, Division of Enforcement of the Securities and Exchange Commission	• Lessons learned from recent SEC enforcement actions involving municipal bond offerings • Current priorities in the Division of Enforcement	Public companies, municipalities, and their auditors
Mark Cheffers, *CEO*, Audit Analytics	• Observations on SEC comment letter research	SEC registrants
Linda L. Griggs, *Partner*, Morgan Lewis Gary R. Kabureck, *Vice President and Chief Accounting Officer*, Xerox Corporation Barry N. Summer, *Associate Director*, Division of Corporation Finance of the Securities and Exchange Commission	• Executive compensation disclosure • Management's discussion and analysis	SEC registrants

Todd E. Hardiman, *Associate Chief Accountant*, Division of Corporation Finance of the Securities and Exchange Commission	• Materiality and large errors • Judgment and the Division of Corporation Finance review process • Appeals process	SEC registrants and auditors SEC registrants
Stephanie L. Hunsaker, *Associate Chief Accountant*, Division of Corporation Finance of the Securities and Exchange Commission	• Consents and experts	SEC registrants
Steven C. Jacobs, *Associate Chief Accountant*, Division of Corporation Finance of the Securities and Exchange Commission	• Management's discussion and analysis of results of operations on a pro forma basis	SEC registrants
Joel K. Levine, *Associate Chief Accountant*, Division of Corporation Finance of the Securities and Exchange Commission	• Interactive data — XBRL	SEC registrants
John W. White, *Director*, Division of Corporation Finance of the Securities and Exchange Commission	• International matters • XBRL • Proxy matters • Other matters	Foreign private issuers SEC registrants
INTERNAL CONTROL OVER FINANCIAL REPORTING AND OTHER AUDITING MATTERS		
Speaker	**Topics Covered**	**Affects**
Martin F. Baumann, *Director of Office of Research and Analysis*, Public Company Accounting Oversight Board George Diacont, *Director of Division of Registration and Inspections*, Public Company Accounting Oversight Board Claudius Modesti, *Director of Division of Enforcement and Investigations*, Public Company Accounting Oversight Board	• PCAOB inspections • PCAOB Office of Research and Analysis • PCAOB disciplinary proceedings	SEC registrants and registered public accounting firms

Richard D. Brounstein, *Member,* Financial Executives International, Representative on the 2007 COSO Monitoring Project Cynthia M. Fornelli, *Executive Director*, Center for Audit Quality Charles E. Landes, *Vice President*, Professional Standards and Services Group for the AICPA, AICPA Representative to COSO Gerald J. Laporte, *Chief*, Office of Small Business Policy, Division of Corporation Finance of the Securities and Exchange Commission D. Keith Wilson, *Associate Chief Auditor*, Public Company Accounting Oversight Board	• Plan to delay requirement to comply with Section 404 (b) of the Sarbanes-Oxley Act of 2002 • SEC smaller-public-company initiatives • PCAOB smaller-firm initiatives • COSO smaller-public-company initiatives	Audit firms Smaller public companies
Steven C. Jacobs, *Associate Chief Accountant*, Division of Corporation Finance of the Securities and Exchange Commission	• Section 404 implementation issues	SEC registrants
Josh K. Jones, *Professional Accounting Fellow*, Office of the Chief Accountant of the Securities and Exchange Commission	• Management's evaluation of internal control over financial reporting	SEC registrants and auditors of public companies
Vassilios Karapanos, *Associate Chief Accountant*, Office of the Chief Accountant of the Securities and Exchange Commission	• Auditor independence	SEC registrants and auditors of public companies
Zoe-Vonna Palmrose, *Deputy Chief Accountant*, Office of the Chief Accountant of the Securities and Exchange Commission	• Improving effectiveness of 404 implementation • Sustaining a vibrant audit profession • SEC's oversight of the PCAOB • Anwers to audience questions	SEC registrants and auditors of public companies
	INTERNATIONAL FINANCIAL REPORTING	
Speaker	**Topics Covered**	**Affects**
Julie A. Erhardt, *Deputy Chief Accountant*, Office of the Chief Accountant of the Securities and Exchange Commission	• Feedback received on SEC concept release	U.S. registrants
Josh K. Jones, *Professional Accounting Fellow*, Office of the Chief Accountant of the Securities and Exchange Commission	• Management's evaluation of internal control over financial reporting for foreign private issuers	Foreign private issuers

Len Jui, *Associate Chief Accountant*, Office of the Chief Accountant of the Securities and Exchange Commission	• International initiatives to encourage improvements in audit quality	SEC registrants, foreign private issuers, and auditors of public companies
Katrina A. Kimpel, *Professional Accounting Fellow*, Office of the Chief Accountant of the Securities and Exchange Commission	• Faithful and consistent application of IFRSs	Preparers, auditors, regulators, and standard setters
James J. Leisenring, *Member*, International Accounting Standards Board	• IFRSs and convergence projects with the FASB	Preparers, auditors, and users of IFRS financial statements
Janet Luallen, *Associate Chief Accountant*, Office of the Chief Accountant of the Securities and Exchange Commission	• Update on international regulatory initiatives of IOSCO	Foreign private issuers
Craig C. Olinger, *Deputy Chief Accountant*, Division of Corporation Finance of the Securities and Exchange Commission	• Profile of foreign private issuers • Proposed rule on acceptance from foreign private issuers of financial statements prepared in accordance with IFRSs without reconciliation to U.S. GAAP • Reviews of IFRS filings • U.S. GAAP reconciliation • Reporting issues	Foreign private issuers

The speeches of certain SEC staff members are available on the Commission's Web site at www.sec.gov. Please remember that though our goal is to be as accurate as possible, we have not confirmed the accuracy of this *Heads Up* with the SEC staff or with any other organization we refer to.

Members of the following Deloitte teams contributed to this issue of *Heads Up*: Accounting Standards and Communications, Assurance Services, Independence, Quality Assurance, and SEC Services. To our colleagues at Deloitte, our clients, and our other friends, we wish each of you a joyous and peace-filled holiday season and a happy new year.

Summaries of Speeches and Other Comments

2007 AICPA National Conference on Current SEC and PCAOB Developments

KEYNOTE SPEAKERS

Speeches by:

Kathleen L. Casey, *Commissioner*, Securities and Exchange Commission
Randy G. Fletchall, *Chairman*, American Institute of Certified Public Accountants
Conrad W. Hewitt, *Chief Accountant*, Securities and Exchange Commission

Topics Covered	Affects
• Convergence and the use of IFRSs • Complexity, professional judgment, and the role of the CIFiR • The SEC's actions on the current state of the financial markets • XBRL • Auditor independence	Preparers, auditors, regulators, and users of financial statements

Convergence and the Use of IFRSs

Mr. Fletchall noted the rapid pace of activity concerning the use of IFRSs, citing (1) the SEC's decision to accept from foreign private issuers financial statements prepared in accordance with IFRSs (as published by the IASB) without reconciliation to U.S. GAAP and (2) the SEC's concept release on giving U.S. issuers the option to prepare financial statements filed with the SEC in accordance with IFRSs.

Ms. Casey indicated that the SEC eliminated the reconciliation only after considering three threshold issues:

- Whether the process toward convergence was sufficiently robust.
- Whether IFRSs were being consistently and faithfully applied.
- Whether the processes of the IASB were fair and transparent.

She believes that "the benefits of achieving our ultimate goal of developing a single set of high quality standards exceeded the potential costs of postponing our decision on reconciliation until greater convergence was achieved between the FASB and IASB." She indicated that investors are better served by the SEC's active participation in shaping future IFRS initiatives.

Ms. Casey also noted that the comment letters received on the SEC's concept release are similar to those received on the proposal to eliminate the reconciliation requirement. She stated, "No one questions the benefits of convergence or of a single set of global standards. People differ, however, and differ strongly, on the best plan for getting there." She continued by stating that there will be two roundtable sessions in mid-December to explore (1) whether U.S. investors and issuers have an interest in IFRSs and (2) other practical issues.

Editor's Note: See Deloitte & Touche LLP's December 18, 2007, *Heads Up* for additional information on the roundtables.

Mr. Fletchall added that the AICPA supports "the goal of a single set of high quality, comprehensive accounting standards to be used by public companies in the preparation of transparent and comparable financial reports throughout the world." He emphasized that as the accounting profession moves to a single set of globally accepted accounting standards for public companies, changes need to occur in the U.S. auditing, regulatory, and legal environments. Mr. Fletchall added that for convergence to be successful, the AICPA will need to fulfill certain responsibilities, including the following:

- Educating its members about IFRSs.
- Working with accounting educators, textbook authors, and educational institutions to prepare future professionals.
- Incorporating IFRSs into the Uniform CPA Examination.

Supporting Mr. Fletchall's remarks, Ms. Casey indicated that convergence in auditing standards would complement the benefits of a global set of accounting standards. She viewed the PCAOB's recent proposal that establishes a framework for cooperation with and reliance on foreign jurisdictions in inspections of non-U.S., PCAOB-registered auditing firms as "an important corollary to our efforts on accounting convergence."

Editor's Note: See the proposed policy statement on the PCAOB's Web site.

Complexity, Professional Judgment, and the Role of the CIFiR

Ms. Casey remarked that with the significant and rapid change happening in the accounting and auditing profession, predicting what the future holds for the profession is difficult. She noted that the good news is that many of the changes afoot, "some driven by market forces and developments, others a product of the regulatory and legal landscape and the SEC and PCAOB's efforts on a variety of fronts — all have the promise of a new and improved paradigm in financial reporting, accounting, and auditing standards."

Mr. Fletchall echoed that sentiment, indicating that the accounting profession must cope with a considerable amount of sometimes unavoidable complexity. He added that it has been, and will continue to be, the job of CPAs, both preparers and auditors, to make understandable the dramatically changing and increasingly complex financial world.

Both Ms. Casey and Mr. Fletchall emphasized that, in the current rules-based environment, one cause for the large number of recent restatements has been regulatory second-guessing and overturning the decisions reached on complex issues. They added that with standards that rely on professional judgment comes the possibility of reaching different conclusions on issues, even "when operating in good faith." Ms. Casey added that a principles-based framework may improve the quality of financial information by emphasizing "qualitative disclosure."

Mr. Fletchall indicated that the AICPA believes that the U.S. Treasury Department's Advisory Committee on the Auditing Profession should consider factors in the U.S. regulatory and legal systems that clearly need to be addressed to provide an environment in which professional judgment is respected.

The speakers cited the activities of the SEC's Advisory Committee on Improvements to Financial Reporting (CIFiR) as initial steps toward reducing complexity and encouraging sound professional judgment. Both Mr. Hewitt and Ms. Casey indicated that with the increase in restatements, they will be interested in the CIFiR's work in considering the interplay of factors such as complexity and the definition of materiality.

Editor's Note: See the summary of remarks by Robert Pozen, chairman of the CIFiR, for an overview of the current status of the organization's activities.

The SEC's Actions on the Current State of the Financial Markets

Ms. Casey indicated the following new steps taken by the SEC to address liquidity, credibility, and transparency issues in the current financial market environment:

- The Commission is supervising the five largest securities firms in a "manner similar to how a bank holding company would be supervised by the Federal Reserve." The SEC will require a holding company of these entities to "have sufficient stand-alone liquidity to meet its expected cash outflows in a stressed liquidity environment for a period of at least one year." In addition, the SEC will monitor these entities' liquidity holding positions frequently.
- The staff of the Division of Corporation Finance is issuing comments on disclosures related to subprime developments and is letting issuers know that disclosures must provide adequate information on the effects of subprime loans, commercial paper markets, and other market conditions.

- The Commission is examining credit-rating agencies' methods and procedures for determining ratings for residential mortgage-backed securities.

XBRL

Ms. Casey stated that there is an "interesting parallel" between convergence efforts and the XBRL implementation. While standard setters are converging accounting standards, the U.S. GAAP and IFRS XBRL teams are working to align their taxonomies to ultimately allow a consistent global reporting platform. She noted that the AICPA has taken an early leadership role in developing and promoting XBRL, and she indicated that this is also a top priority of the SEC.

Mr. Fletchall stated that the SEC recently announced the release of an XBRL U.S. GAAP taxonomy and *Preparers Guide* for comment. He also noted that the SEC's voluntary XBRL filing program has contributed to the progress of XBRL for public financial reporting purposes, and that the SEC's investment of more than $50 million in XBRL-related contracts to rebuild the public disclosure system and render it interactive is indicative of XBRL's potential significance to the future of reporting in the United States.

Mr. Hewitt indicated that the SEC has created a new Office of Interactive Disclosure, directed by David Blaszkowsky. He added that the creation of this office demonstrates the SEC's commitment to XBRL and indicated that the office will be helpful to registrants, investors, and other users.

Mr. Hewitt added that SEC Chairman Christopher Cox has requested recommendations from the SEC staff on how to improve the benefits received from XBRL. He indicated two areas the staff will focus on: (1) the level of assurance that might be required on data tagging and (2) the appropriate transition period if use of XBRL is to become mandatory. The staff recommendations are due in the spring of 2008.

Editor's Note: See summary of remarks by Joel K. Levine, associate chief accountant, SEC Division of Corporation Finance.

Auditor Independence

In his discussion on auditor independence rules, Mr. Hewitt remarked that the overall complaint about these rules is that they are "complex and overly prescriptive." He added that he is "supportive of a move to a more principles-based approach to auditor independence that will decrease complexity and converge with the international auditor independence standards."

Speech by Cynthia M. Fornelli, *Executive Director*, Center for Audit Quality

Topics Covered	Affects
• Center for Audit Quality's mission, members, and activities	Preparers, auditors, regulators, and users of financial statements

Speaking for the first time at the conference, Ms. Fornelli discussed the mission of the Center for Audit Quality and its accomplishments over the past 11 months. The CAQ was launched in January 2007 as a public policy organization. It was established to foster confidence in the public auditing profession and the capital markets, and to bring together users of financial information, including auditors, issuers, educators, and investors. Ms. Fornelli explained that the CAQ is working to accomplish its mission by engaging regulators (such as the SEC and PCAOB), stakeholders, researchers, and professional practitioners.

Ms. Fornelli noted that the CAQ's activities over the past year have included involvement with the SEC's Advisory Committee on Improvements to Financial Reporting and the U.S. Treasury's Advisory Committee on the Auditing Profession, the issuance of several technical alerts and comment letters, and holding various webcasts. In addition, the CAQ held a celebration in July to commemorate the fifth anniversary of the Sarbanes-Oxley Act of 2002. This event was designed to generate dialogue regarding the role the Act has played in improving financial reporting. Moreover, in September 2007, the CAQ issued three white papers to address key accounting issues resulting from the turbulent conditions in the credit markets.

Ms. Fornelli also pointed out that the CAQ has embarked on a "public dialogue tour." Covering 10 cities over a one-year period, the CAQ will meet with groups of registrants, investors, regulators, governmental users and overseers, and academics. The goal of the tour is to gather ideas about modernizing financial reporting from the investing and financial reporting community. Although the tour is still in progress, Ms. Fornelli discussed some of the emerging themes:

- *Adequacy of financial reporting* — Participants have indicated that while they receive a lot of information, they don't always find it useful (i.e., they emphasized quality over quantity). They would also like to see the story behind the numbers and predictive information (i.e., what the numbers mean and what the important messages are).
- *Role of auditors* — Participants believe that auditors should be viewed as a vital ally and that they play an important role in fraud detection. Ms. Fornelli also said that participants in the forums believe an "expectations gap" exists between the role that investors want auditors to play and what auditors can realistically do.
- *Impact of technology* — Technology should be employed to customize financial information to meet the needs of different users.

The CAQ will ultimately issue a report outlining the themes from the tour and making recommendations on how to improve financial reporting.

Editor's Note: Additional information on the Sarbanes-Oxley Act anniversary celebration and the public dialogue tour is available on the CAQ's Web site.

Speech by Robert H. Herz, *Chairman*, Financial Accounting Standards Board

Topics Covered	Affects
• Global financial reporting	Preparers, auditors, regulators, and users of financial statements

Addressing one of the themes of the conference, Mr. Herz remarked on the need for a global financial reporting system producing "common, high-quality financial reporting by listed companies around the world." Mr. Herz, the FASB, and the Financial Accounting Foundation believe that of the various paths available to reach this goal, a single set of high-quality accounting standards developed by a single independent standard setter would benefit the global capital markets.

Mr. Herz noted that the United States needs to adopt a comprehensive plan. The plan needs to address a host of issues, ranging from the continued movement of the FASB and the IASB toward improvement and convergence to changes in, for example, education, training, and state laws tied to U.S. GAAP.

Mr. Herz also noted that work needs to be done internationally. That work would include improving (1) convergence of auditing standards and oversight of auditors and (2) consistency among international regulators. Mr. Herz cautioned that the current "as adopted" and "national flavors" versions of IFRSs must be avoided in the future because they threaten the achievement of a common global financial reporting system. He also included greater funding and staffing among the steps needed to strengthen the IASB as the global standard setter.

Editor's Note: Mr. Herz's remarks were consistent with the FASB/FAF comment letter in response to the SEC's *Concept Release on Allowing U.S. Issuers to Prepare Financial Statements in Accordance With International Financial Reporting Standards*, and in response to the SEC's (now adopted) proposal, *Acceptance From Foreign Private Issuers of Financial Statements Prepared in Accordance With International Financial Reporting Standards Without Reconciliation to U.S. GAAP.*

Speeches by:

Mark W. Olson, *Chairman*, Public Company Accounting Oversight Board

Thomas Ray, *Chief Auditor and Director of Professional Standards*, Public Company Accounting Oversight Board

Topics Covered	Affects
• International developments • Auditing Standard 5 • Audit report date • Inspections and enforcement • Auditing fair value measurements • Standard-setting priorities	SEC registrants and auditors of public companies

Mr. Olson and Mr. Ray addressed some of the critical initiatives that are under way at the PCAOB.

Editor's Note: In May of 2007, the PCAOB adopted its first multiyear strategic plan, which sets forth the overall goals of the PCAOB and ensures the alignment of the PCAOB's programs, operations, and budget with the organization's overall mission, goals, and objectives.

International Developments

Cross-Border Cooperation

Mr. Olson emphasized the importance of working closely with other similar regulatory bodies around the world and stated that "mutual oversight and cooperation is fundamental to the global strengthening of audit quality." The PCAOB has invested substantial time in developing relationships with counterparts across the globe and believes such cooperation enhances audit quality and better leverages respective resources. On the basis of these objectives, in early December 2007, the PCAOB issued for public comment a policy statement on enhancing cross-border cooperation with other oversight bodies related to the inspection of firms registered with the PCAOB. The statement establishes a framework that builds on the five principles enumerated in PCAOB Rule 4012. The policy statement articulates an approach that would enable the PCAOB to move beyond joint inspections toward full reliance on oversight bodies in other jurisdictions that meet certain essential criteria, without sacrificing the PCAOB's duty to inspect for compliance with PCAOB standards and issue inspection reports, including a public portion of such reports.

Editor's Note: The proposed policy statement for implementing Rule 4012 can be found on the PCAOB's Web site. The comment period closes on March 4, 2008.

Globalization of Professional Standards

Mr. Olson commented on the need for globally accepted auditing standards, stating that discussions have been initiated with international and domestic standard-setting counterparts.

Mr. Ray stated that in the coming year the PCAOB will be considering and seeking views on:

- Whether there is a need for a set of globally accepted auditing standards.
- How the PCAOB should interact with other auditing standard setters.
- Where global convergence falls with respect to the PCAOB's other priorities.

While the PCAOB has been involved in efforts to minimize differences between U.S. public company auditing standards and the standards developed by the International Auditing and Assurance Standards Board (IAASB), Mr. Ray acknowledged that there are, and will most likely continue to be, differences between the two sets of standards. However, he expressed hope that the development of new PCAOB standards would be accomplished in a manner that will facilitate understanding of those differences.

Effect of Eliminating U.S. GAAP Reconciliation

Given the SEC's recent actions related to foreign private issuers filing financial statements prepared in accordance with IFRSs, as published by the IASB, without reconciliation to U.S. GAAP, the PCAOB is considering the resulting implications to the Interim Quality Control Standards contained in Appendix K. Affected provisions include the following:

- Appendix K directs a person knowledgeable in U.S. accounting, auditing, and independence requirements to review a sample of audit engagements performed by foreign associated firms for SEC registrants to determine compliance with U.S. GAAP (the "filing reviewer"). This determination would not be applicable to filings that contain no U.S. GAAP.
- Appendix K directs the filing reviewer to discuss, with the partner in charge of the engagement, the engagement team's familiarity with and understanding of U.S. accounting and financial reporting standards and the significant differences between the accounting and financial reporting standards used in the filing and those applicable in the United States. These provisions, which are specific to U.S. GAAP, are not applicable to a filing that contains no U.S. GAAP.

Mr. Ray also noted that the following filing review procedures are still applicable to filings that do not contain any U.S. GAAP:

- Reading the document to be filed with the SEC.
- Discussing, with the partner in charge of the engagement, the engagement team's familiarity with and understanding of applicable U.S. auditing and independence standards and requirements, as well as significant differences between the applicable U.S. standards and requirements and the auditing and independence standards of the foreign associated firm's domicile country.
- Discussing, with the partner in charge of the engagement, significant auditing, accounting, financial reporting, and independence matters that come to the attention of the filing reviewer when performing the filing review procedures.

Mr. Ray stated that the PCAOB staff is evaluating whether changes should be made to Appendix K or to other PCAOB standards and rules to clarify how the standards apply when financial statements are prepared according to IFRSs.

Editor's Note: Appendix K is part of the PCAOB Interim Quality Control Standards, which were adopted from the SEC Practice Section — Requirements of Membership. Appendix K can be found in Section 1000.08(n), "Audit Firm Obligations With Respect to the Policies and Procedures of Correspondent Firms and of Other Members of International Firms or International Associations of Firms."

Auditing Standard 5

Both Mr. Olson and Mr. Ray discussed Auditing Standard No. 5.

Editor's Note: See Deloitte & Touche LLP's May 31, 2007, *Heads Up* for highlights of Auditing Standard 5, as well as some of the notable differences between the new standard and Auditing Standard 2.

Mr. Olson acknowledged that the development and issuance of Auditing Standard 5 to replace Auditing Standard 2 had been a major focus of the PCAOB. Mr. Ray stated that Auditing Standard 5 "eliminates requirements that resulted in unnecessary procedures, is less prescriptive, and more clearly identifies the principles that drive the auditor's work and judgments." However, at the same time the new standard embodies the key principles of Auditing Standard 2.

Mr. Olson and Mr. Ray noted that the new standard incorporates the following features:

- A top-down, risk-based approach that is meant to focus on the areas of greatest importance to financial reporting for each public company.
- Consideration of risk throughout the audit process.
- Emphasis on the control environment, period-end financial reporting controls, and antifraud controls.
- Scalability (which is further discussed in its Preliminary Staff Views issued for smaller companies).

Editor's Note: Preliminary Staff Views, *An Audit of Internal Control That Is Integrated With an Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies*. Comments were due on December 17, 2007.

See additional comments on small business reporting issues in the summary of remarks by D. Keith Wilson.

Mr. Olson acknowledged that Auditing Standard 5 places greater emphasis on the professional judgment of the auditor than did Auditing Standard 2. He indicated that inspectors will evaluate the judgment exercised by auditors fairly to provide an environment that encourages them to use judgment when appropriate.

Accordingly, PCAOB inspectors will receive training on:

- The critical decisions that went into the development of the new standard.
- Evaluating auditor judgment.

Mr. Olson further elaborated on the inspection process, indicating that when the inspectors examined areas that involved judgment, a primary consideration was the auditor's documentation of the extent to which they applied relevant standards in making their judgments.

Audit Report Date

Mr. Ray noted that the adoption of Auditing Standard 5 resulted in a change to the way the auditor determines the audit report date, which now should be dated no earlier than the date on which the auditor has obtained sufficient competent evidence to support his or her opinion, rather than the date of completion of fieldwork. This change makes the PCAOB's standard on report dating consistent with that of the IAASB and Auditing Standards Board (ASB).

Inspections and Enforcement

Mr. Ray noted that during 2007, the PCAOB published three general reports under the Board's Rule 4010 concerning the procedures, findings, and results of its various inspections:

- A report on the implementation of standards related to the auditor's responsibility with regard to the consideration of fraud.
- A report on the second-year implementation of Auditing Standard 2.
- Observations identified in the first three years of inspecting U.S. registered public accounting firms that audit 100 or fewer issuers.

Auditing Fair Value Measurements

Mr. Ray noted that the PCAOB has published Staff Audit Practice Alert No. 2, *Matters Relating to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists*, principally in response to the challenges presented by the credit market environment, and certain potential issues arising from the transition to Statement 157. The alert addresses the following four areas:

- Auditing fair value measurements.
- Classification in the fair value hierarchy under Statement 157.
- Use of specialists in fair value measurements.
- Use of a pricing service.

Mr. Ray also noted that SAS 101 is the relevant PCAOB interim standard, and reminded the audience that relevant market inputs should be used in auditing fair measurements, even in unusually volatile markets.

Editor's Note: PCAOB Staff Audit Practice Alert No. 2 was released on December 10, 2007.

Standard-Setting Priorities

Mr. Ray identified the current standard-setting priorities of the Board, which include the following:

- Engagement quality review.
- Revision of interim risk assessment standards.
- Evaluation of PCAOB interim standards.

Mr. Ray expressed his view that the risk assessment standards of the IAASB and ASB include improvements over the

PCAOB's interim risk assessment standards, and the PCAOB is leveraging these improvements in its work to revise the PCAOB's interim risk assessment standards. Mr. Ray also stated that the PCAOB will be developing a more defined schedule and procedure for reviewing all the PCAOB's interim standards and that it will be seeking advice from the Board's Standing Advisory Group (SAG) in the coming year.

Mr. Ray also referenced the October 2007 SAG meeting materials, which included a discussion of the PCAOB's standard setting agenda.

Editor's Note: The SAG's Standards-Setting Priorities as of October 2007 can be found on the PCAOB's Web site.

U.S. ACCOUNTING PRINCIPLES

Speech by Mark J. Barrysmith, *Professional Accounting Fellow*, Office of the Chief Accountant of the Securities and Exchange Commission

Topics Covered	Affects
• Market instruments used to measure fair value of share-based payments	Entities that grant employee share-based payment awards
• Revenue recognition: whether joint steering committee participation is a "deliverable"	Entities party to multiple-element revenue arrangements that include steering committees
• Product and service revenue presentation	Entities with multiple-element revenue arrangements involving both products and services

Market Instruments Used to Measure Fair Value of Share-Based Payments

Statement 123(R) explicitly states that observable market prices of identical or similar equity or liability instruments in active markets are the best evidence of fair value and, if available, should be used as the basis for measuring share-based payment transactions with employees. Only in the absence of such observable market prices should other valuation techniques be used (e.g., modeling techniques).

In his remarks, Mr. Barrysmith stated that in the past, the staff has discussed ways in which one might design an equity or liability instrument to meet the measurement objective of Statement 123(R). He noted that in particular, the staff has discussed "1) instruments that layoff an [employer's] obligation related to share-based payments to a third party, and 2) instruments sold into an open market that track the payout to recipients of a share-based payment." Mr. Barrysmith acknowledged that these two instruments have potential upward and downward price biases, respectively. The staff of the Office of the Chief Accountant has spoken with many registrants regarding the design of such instruments, but Zions Bancorporation is the only company believed to have any such instruments in the marketplace.

> **Editor's Note:** Entities tend to favor the tracking instrument over the layoff instrument because of its downward pricing bias. A downward bias is advantageous both to the company issuing the tracking instrument, since it drives down the compensation cost recorded in its financial statements, and to the investors buying the tracking instrument as it reduces their cost to purchase the instrument. For further discussion of Zions's tracking instrument, see Deloitte & Touche LLP's October 24, 2007, *Heads Up* on the SEC's approval of Zions Bancorporation's use of ESOARS ("employee stock option appreciation rights securities").

Because of the inherent pricing biases of these two instruments, the potential exists for a significant pricing spread between them. Mr. Barrysmith noted that because of the pricing biases, two questions are frequently posed:

- "How large can the pricing spread between these instruments be, while still allowing for the assertion that both are representative of fair value?
- What price or range of prices within the spread is acceptable for the purpose of measuring employee share options?"

While Mr. Barrysmith noted that the answers to these questions require judgment, he also indicated that one must first look to the motivation for using a market instrument before exercising "boundless judgment." For example, use of a market instrument simply to reduce compensation cost is not an appropriate motivation. However, with the proper amount of focus on instrument design and creation of a competitive market for the instrument, it becomes possible to minimize the pricing spread and, as a result, generate a reasonable estimate of fair value under Statement 123(R)'s measurement objective.

Mr. Barrysmith expects a pricing spread between the layoff and tracking instruments to continue to exist for the foreseeable future, but believes the spread will narrow if a market for these instruments matures. Until then, in the absence of a secondary market for these instruments that supports the assumption that the clearing price is within a reasonable spread, companies will need to benchmark the market clearing price for these instruments. While clarifying that the SEC staff recognizes that the goal is to benchmark the clearing price and not to reconcile it to a model price, Mr. Barrysmith indicated that the SEC staff recently accepted a comparison to prices developed through generally accepted modeling techniques as a means to benchmark. In this regard, he stated that "provided that the spread is not affected by flaws in the instrument design or the issuer's marketing approach, we are willing to accept prices that fall within a reasonable spread."

Revenue Recognition: Whether Joint Steering Committee Participation Is a "Deliverable"

Mr. Barrysmith stated that the SEC staff has received numerous inquiries about whether a vendor's participation on a joint steering committee (for instance, in a collaborative research and development arrangement) constitutes a deliverable for consideration under Issue 00-21 and SAB 104. The SEC staff's response to these inquiries has been that if vendor participation on the joint steering committee is required by the related agreement or if by failing to participate, the vendor's performance could be called into question, the vendor's participation is presumed to be obligatory and, therefore, should be evaluated as a potential deliverable.

> **Editor's Note:** Joint steering committees are often created in collaborative research and development arrangements to ensure that the parties reach their goals. While the SEC staff referred to collaborative research and development arrangements, the issues surrounding steering committees may be applicable in other revenue arrangements.

Mr. Barrysmith noted that the SEC staff generally finds that when a vendor is obligated to participate on the joint steering committee, the purpose is to incorporate specialized expertise possessed by the vendor. When vendor participation on the joint steering committee is optional, participation is often viewed as a right and is perceived as a means to protect the vendor's interest.

While the term "deliverable" is not defined in the accounting literature, Mr. Barrysmith noted that a deliverable is sometimes considered to have one or more of the following attributes:

1. "is explicitly referred to as an obligation of the vendor in a contractual arrangement,
2. requires a distinct action by the vendor,
3. if not completed by the vendor would result in a significant contractual penalty, or
4. if included or excluded from the arrangement would cause the arrangement fee to vary by more than an insignificant amount."

Mr. Barrysmith said that when evaluating whether a vendor's obligations under an arrangement rise to the level of a deliverable, entities should focus on their obligations under the arrangements and use the above criteria as a starting point. Collectively, these criteria, along with his above remarks and the discussion of inconsequential or perfunctory deliverables in SAB 104, provide a general principle that should be applied in these arrangements.

Product and Service Revenue Presentation

SEC Regulation S-X, Rule 5-03(b) requires that product and service revenue, along with other categories of revenue, be displayed separately on the income statement. As noted by Mr. Barrysmith, a frequent question is how a vendor might adhere to this requirement when it is unable to separate its multiple-element arrangements under applicable revenue recognition guidance, such as Issue 00-21 or SOP 97-2. Mr. Barrysmith indicated that because investors find the disaggregation of this information useful, the staff does not believe that the inability to separate deliverables for recognition purposes necessarily precludes separate display of product and service revenue. As long as there is a reasonable basis for the separation methodology and it is consistently applied, clearly disclosed, and not misleading, the SEC would not, according to Mr. Barrysmith, object to the separate presentation of product and service revenue. He further noted that this view is not limited to product and service revenue and would be applicable to other categories of revenues.

In discussing the application of reasonable judgment, Mr. Barrysmith suggested that separating revenues from products and services on the basis of a reasonable approximation of fair value may be appropriate in certain circumstances, even when the deliverables cannot be separated for recognition purposes. For example, for transactions within the scope of SOP 97-2, a comparison to third-party evidence of fair value for similar products or services may be appropriate. Likewise, the use of the residual method when a vendor customizes its products may also be appropriate. However, he cautioned that a systemic allocation that is solely based on consistency or on contractually stated amounts would not be acceptable. In closing, he emphasized that separation of product and service revenue is a matter of judgment and that the staff is willing to accept the use of judgment as long as it is reasonable, consistently applied, and clearly disclosed.

Editor's Note: Mr. Barrysmith emphasized that clear disclosures are key — both in the footnotes and MD&A (e.g., MD&A should indicate why the entity has chosen to separate or combine product and services revenue for presentation purposes).

In another session, Mr. Barrysmith indicated that revenue recognition is particularly challenging when arrangements involve multiple cash flow streams, yet multiple deliverables must be combined into a single unit of accounting. He stated that U.S. GAAP does not directly address this dilemma and that the SEC staff is aware of certain methods used in practice (e.g., the substantive milestone method that ties revenue recognition to certain performance milestones). He clarified that by applying certain of these methods, one may end up with multiple attribution methods for a single unit of account. He cautioned that entities should ask themselves whether it is appropriate to have multiple attribution streams for a single unit of account.

Panel Discussion on Technical Accounting Issues by:

Mark J. Barrysmith, *Professional Accounting Fellow*, Office of the Chief Accountant of the Securities and Exchange Commission

Ashley W. Carpenter, *Professional Accounting Fellow*, Office of the Chief Accountant of the Securities and Exchange Commission

Michael D. Foley, *Partner*, KPMG LLP

Russell Hodge, *Global Controller — Center of Excellence*, General Electric

Paul Munter, *Partner*, KPMG LLP

Brian Stevens, *Practice Fellow*, Financial Accounting Standards Board

Topics Covered	Affects
• Impact of market illiquidity on fair value measurements and the role of the Center for Audit Quality	Entities with certain illiquid investments (e.g., subprime mortgage loans)
• Debt and equity issues	Entities that issue convertibles or other financial instruments settled in their own shares (other than share-based payments to employees)
• Interpretation 48 issues	Entities with uncertain tax positions

Impact of Market Illiquidity on Fair Value Measurements and the Role of the Center for Audit Quality

Panelists were asked for their perspectives on three recent white papers[3] issued by the CAQ that address accounting issues related to current market liquidity and credit issues. The panelists focused on the "Measurements of Fair Value in Illiquid (or Less Liquid) Markets" white paper.[4] Mr. Foley noted that this paper was drafted to address an incorrect belief that if the entire credit market was judged to be *distressed*, then market data might be ignored, in favor of internal models, for valuing certain asset classes (e.g., subprime loans). The white paper clarifies that an imbalance in supply and demand in a market affects liquidity, a factor in determining fair value, but that the term *distress* is used in GAAP (e.g., Statement 157) in the context of a specific transaction and does not characterize a market.

Mr. Stevens noted that when an entity uses a valuation model to determine fair value (e.g., when little or no observable market data is available) the objective is to arrive at a **current** market price, not the price that the entity thinks it should be or might be in the future.

Has the CAQ been setting GAAP? Mr. Foley refuted this contention, adding that the white papers are intended to increase awareness of existing U.S. GAAP requirements. Mr. Carpenter added that the SEC does not endorse papers such as these, although the CAQ had shared the papers with the staff. Mr. Hodge observed that despite the CAQ's good intentions, some may believe it is attempting to assume a standard-setting role.

Editor's Note: See Deloitte & Touche LLP's October 3, 2007, *Financial Reporting Alert* for additional information related to the CAQ white papers. Also, see the summary of remarks by Cynthia Fornelli for additional information on the CAQ.

Debt and Equity Issues

The panel discussed Issue 07-5 and the EITF's attempts to clarify when an entity can consider contracts involving an entity's own shares to be "indexed to its own stock." For contracts and embedded features that would otherwise be within the scope of Statement 133 (e.g., an option or forward on an entity's own shares), indexing to an entity's own stock is a key factor in determining whether the instrument meets the scope exception in Statement 133 for contracts that are both (1) indexed to and (2) classified in equity.

3 The white papers are available on the CAQ's Web site.

4 The other two white papers are entitled "Consolidation of Commercial Paper Conduits" and "Accounting for Underwriting and Loan Commitments."

Some observations were made during the discussion:

- Mr. Stevens noted that a working group has been formed for Issue 07-5 and that the Issue has the potential to narrow the scope of instruments classified in equity under GAAP.
- Mr. Carpenter added that the SEC staff supports the EITF's effort to determine what is intended by the phrase "indexed to an entity's own stock." Mr. Carpenter cautioned that entities should carefully evaluate the terms of agreements to determine whether the instrument (1) is indexed to the entity's own stock **and** (2) meets the requirements for equity classification in Issue 00-19 (another consideration in determining whether an instrument is a Statement 133 derivative, liability, or equity).

Editor's Note: See Deloitte & Touche LLP's November 2007 *EITF Snapshot* for additional information related to EITF Issue 07-5.

Mr. Stevens also provided background on the FASB's proposed FSP APB 14-a, which would change the current accounting for certain convertible instruments. The FSP would require entities to separately account for the liability and equity components of certain convertible instruments to reflect the entity's economic cost of borrowing (i.e., not a reduced interest rate that is influenced by the value of the equity option). The comment letter process has ended and respondents generally opposed the FSP, citing concerns about increased interest cost, inconsistency with GAAP for other convertible instruments, a "too-soon" effective date, and retrospective transition. The Board intends to begin its redeliberations in January 2008. Mr. Stevens indicated that any final FSP would not likely be effective until 2009 for calendar year-end entities.

Editor's Note: See Deloitte & Touche LLP's September 14, 2007, *Heads Up* for additional information on FSP APB 14-a.

Interpretation 48 Issues

In the coming weeks, the FASB plans to issue for public comment a proposed FSP that would delay for one year the effective date of Interpretation 48 for **nonpublic** entities that have not yet applied it. Thus, a nonpublic entity that has not yet applied Interpretation 48 would first apply it for fiscal years beginning after December 15, 2007. Additionally, Mr. Stevens indicated that, as defined in Statement 109, a nonpublic entity is any entity other than an entity (1) with publicly traded debt or equity securities, (2) that is a conduit bond obligor for conduit debt securities that are traded in a public market, or (3) with financial statements that are filed with a regulatory agency in preparation for a public offering for any class of securities.

Editor's Note: See Deloitte & Touche LLP's November 7, 2007, *Financial Reporting Alert* for additional information related to the FASB's proposed deferral of FIN 48 for nonpublic entities.

Speech by Ashley W. Carpenter, *Professional Accounting Fellow*, Office of the Chief Accountant of the Securities and Exchange Commission

Topics Covered	Affects
• Classification of loan receivables	Entities with loan receivables balances
• Other-than-temporary impairment of securities	Entities holding debt and equity securities
• Initial adoption of Statement 159	Entities with held-to-maturity and available-for-sale securities at adoption of Statement 159
• Accounting for equity derivatives	Entities with equity derivatives

Classification of Loan Receivables

Mr. Carpenter discussed the classification of loan receivables as either held-for-investment or held-for-sale. He focused on the following three issues:

- The role of management assertions.
- The definition of "foreseeable future."
- The unit of account.

Management assertions — Mr. Carpenter noted that the staff often receives inquiries from registrants asking if there is a default classification for loan receivables under Statement 65 and SOP 01-6.[5] For example, some ask whether a registrant could appropriately classify a loan as held-for-investment without making a positive assertion regarding the registrant's ability and intent not to sell a specific loan within one year. This would be analogous to the default classification of long-lived assets as held-and-used under Statement 144. Mr. Carpenter said that the SEC staff generally believes that this approach would be inappropriate because it is not always consistent with management's intent. Management should consider all relevant information and make a positive assertion regarding its ability and intent to hold or sell loan receivables.

Definition of "foreseeable future" — Mr. Carpenter acknowledged that the definition of the foreseeable future is one of the more important judgments in determining management's intent. He said the SEC staff believes there is no "bright line" period to quantify what constitutes "foreseeable future." Instead, management's accounting policies should include a definition of the foreseeable future that is reasonable under the circumstances and considers the following factors:

- The strategy and current plan for the business.
- The nature, type, and expected life of the loan receivable.
- The current financial condition and liquidity demands of the entity.
- The current economic environment and market conditions.
- The past practices of holding and selling loan receivables.

Changes in relevant factors may also change the definition of "foreseeable future"; however, management should scrutinize the appropriateness of a change in factors concurrent with its reclassification of loan receivables and provide appropriate disclosures in its financial statements.

Mr. Carpenter also stated that the SEC staff would accept different judgments that are reasonably formulated and based on all relevant information. For example, the SEC staff has accepted a holding period for a credit card receivable that is shorter than that for an automobile loan receivable in determining whether a loan is held for the foreseeable future because of the characteristics of the loans. However, the SEC staff has disagreed with certain general applications of the term "foreseeable future," including: (1) an "imminent" period because management has not precisely budgeted its loan

[5] Statement 65 states that "a mortgage loan shall not be classified as a long-term investment unless the mortgage banking enterprise has both the ability and the intent to hold the loan for the foreseeable future or until maturity." SOP 01-6 states that "loans and trade receivables that management has the intent and ability to hold for the foreseeable future or until maturity or payoff should be reported in the balance sheet at outstanding principal adjusted for any chargeoffs, the allowance for loan losses (or the allowance for doubtful accounts), any deferred fees or costs on originated loans, and any unamortized premiums or discounts on purchased loans." [Footnote omitted]

sale activity and (2) the period between the acquisition date and the date a specific loan is identified for sale. In addition, if a registrant asserts that the "foreseeable future" is a "period until the market recovers," the reasonableness of such an assertion depends on the specific circumstances, including the anticipated recovery period.

Unit of account — Mr. Carpenter stated the SEC staff has accepted an entity's classification of loan receivables either at a loan-by-loan level or at a group level. Management should adopt a consistent and appropriate accounting policy according to its specific facts and circumstances and should appropriately disclose its accounting policy and any impact to the financial statements.

Example

If a registrant intends to sell a portion (certain percentage) of a pool of similar loans but has not yet identified which specific loans are to be sold, it can classify a percentage of the entire loan pool as held-for-investment and a percentage as held-for-sale.

Other-Than-Temporary Impairment of Securities

Mr. Carpenter discussed the evaluation for other-than-temporary impairments under Statement 115 as follows:

- Management's *inability* to hold a security until recovery indicates the existence of an other-than-temporary impairment, regardless of the specific circumstances of the market decline. Factors to consider include contractual constraints, liquidity, and capital needs of the entity. An example of a contractual constraint would be the granting of unconditional investment-decision-making authority to a third-party investment manager, effectively resulting in management's relinquishing its ability to hold until recovery.
- Management must *assert* its intent to hold a security until its value recovers to conclude that the impairment is temporary.
- Management must estimate the *recovery period* to support a conclusion that impairment is temporary. This estimate should be based on all available information — both positive and negative. Examples of considerations in determining the estimated recovery period include (1) the severity and duration of the impairment, (2) the historical and implied price volatility of the security, (3) post-closing changes in the fair value of the security, (4) the financial condition and near-term prospects of the security's issuer, and (5) whether the decline was affected by macroeconomic conditions or ones specific to the individual security. Mr. Carpenter stated that while the SEC staff does not have "bright lines" in mind for the anticipated recovery period, there are practical limitations on the period of time. As the length of time increases, persuasive evidence necessary to conclude that an impairment is temporary also increases.

Initial Adoption of Statement 159

Mr. Carpenter also discussed the initial adoption of Statement 159 for held-to-maturity or available-for-sale securities. Entities planning to elect the fair value option are nonetheless required to consider other-than-temporary impairments as of their balance sheet date preceding adoption of Statement 159. If an other-than-temporary impairment exists as of the preceding balance sheet date, the impairment should be recognized in income during the preceding period and not included in the cumulative-effect adjustment on Statement 159's adoption.

Additionally, Mr. Carpenter noted that management must reassess the classification of held-to-maturity securities as of the balance sheet date preceding the election of Statement 159. If the held-to-maturity classification is no longer appropriate, the security should be reclassified to available-for-sale during that preceding period. This reclassification would not call into question the continued classification of other held-to-maturity securities provided the adoption of Statement 159 is "substantive." Mr. Carpenter stated that a reclassification from held-to-maturity to trading before an entity's adoption of Statement 159 "would not seem appropriate."

Accounting for Equity Derivatives

Mr. Carpenter stated that when evaluating whether an equity derivative is (1) indexed to the company's stock and (2) classified in stockholders' equity, contract provisions in the trade confirmation and any related International Swaps and Derivatives Association (ISDA) agreements should be carefully analyzed.

The SEC staff has not taken a definitive position on whether provisions of ISDA agreements are consistent with the indexation requirements in Issue 01-6, although it is aware of diversity in practice. The staff believes that in reaching a conclusion, management should carefully consider all applicable provisions in the transaction confirmation and any related ISDA agreements. The staff understands that ISDA agreements may allow for net-cash settlement if events arise that are beyond the registrant's control. In the absence of an *overriding* provision in a transaction confirmation that allows a registrant to share-settle a contract if these events occur, Mr. Carpenter said the contract may not meet the equity classification requirements in Issue 00-19. He encouraged management and auditors to consult with the Office of the Chief Accountant when specific questions arise.

Panel Discussion on Business Combinations by:
Allan Cohen, *Assistant Controller*, Time Warner
Jan R. Hauser, *Partner*, PricewaterhouseCoopers LLP
Stefanie Tamulis, *Project Manager*, Financial Accounting Standards Board

Topics Covered	Affects
• Statements 141(R) and 160	Companies consummating business combinations and companies with noncontrolling interests

Ms. Hauser and Ms. Tamulis summarized the significant changes to the accounting for business combinations and minority interests (now referred to as noncontrolling interests) as a result of the issuance of Statements 141(R) and 160.

The issuance of the statements marks the completion of the first joint standard with the IASB and represents another step toward global convergence. Three key project objectives were noted: (1) development of a single, high-quality business combination standard that can be used for cross-border financial reporting; (2) improvement of the completeness, relevance, and comparability of financial information provided about business combinations; and (3) simplification of the accounting for business combinations.

Editor's Note: See Deloitte & Touche LLP's December 12, 2007, *Heads Up* for additional information related to Statements 141(R) and 160. Note that the effective date for both standards is fiscal years beginning on or after December 15, 2008.

Mr. Cohen was asked to provide practical perspectives on how the new guidance affects preparers of financial statements. He made the following observations:

- *Fair value measurements* — Companies may face challenges in identifying marketplace participants, as that term is used in Statement 157, to develop assumptions used in valuation models.
- *Pre-acquisition contingencies* — Companies may face implementation issues in determining what represents a sufficient amount of new information to trigger a remeasurement event.
- *Contingent consideration* — Companies may face challenges in developing valuation models that properly reflect the acquisition date and subsequent-period fair value measurements of the contingent consideration agreements.
- *Measurement period* — Unlike in current practice, in which acquirers account prospectively for adjustments to provisional amounts recorded during the allocation period following a business combination, an acquirer is required under Statement 141(R) to revise comparative information for prior periods presented. Mr. Cohen identified as a potential issue whether SEC registrants would have to recast previously filed financial statements if the adjustments to provisional amounts have been recorded in a subsequent period and the registrant intends to file a registration statement.
- *Income statement classification* — Mr. Cohen questioned the income statement classification (i.e., operating or nonoperating) of the following under Statement 141(R): transaction costs, income related to reversing excess estimates of contingent consideration, and changes in the fair value of preacquisition contingent liabilities.

Speeches by:

G. Michael Crooch, *Vice-Chairman*, Financial Accounting Standards Board

Russell G. Golden, *Director of Technical Application and Implementation Activities,* Financial Accounting Standards Board

Tom Hoey, *Director of the FASB Codification Project*, Financial Accounting Standards Board

Richard R. Petersen, *Managing Director*, Financial Reporting Advisors, LLC

Topics Covered	Affects
• AcSEC activities • FASB initiatives • FASB projects (including joint projects with the IASB) • EITF activities • FASB codification project	Preparers, auditors, regulators, and users of financial statements

AcSEC Activities

In his summary of the Accounting Standards Executive Committee's current activities, Mr. Petersen discussed the issuance of SOP 07-1, which clarifies the scope of the AICPA Audit and Accounting Guide *Investment Companies*. The FASB has proposed to indefinitely defer the effective date of SOP 07-1 while it reconsiders some of the guide's issues.

Mr. Petersen also referenced the working draft of a Technical Practice Aid, "Convertible Debt, Convertible Preferred Shares, Warrants, and Other Equity-Related Financial Instruments," which addresses the complex area of equity derivatives. The document aggregates many individual pieces of authoritative literature in a flowchart intended to help users determine whether an equity derivative is freestanding or embedded in another instrument.

Finally, Mr. Petersen noted that AcSEC's future focus largely will be on reviewing and revising the industry audit and accounting guides. Revisions to the guides will not be authoritative, but rather emphasize best practices for relatively unique transactions in specific industries.

Editor's Note: The working draft of the Technical Practice Aid is available free of charge on the AICPA's Web site.

FASB Initiatives

Mr. Golden discussed the following two standard-setting initiatives currently underway at the FASB:

- *Understandability* — To improve communication, principles in each FASB standard (including exposure drafts, final documents, and EITF consensuses) will be presented in boldface and will be supported by a discussion intended to aid implementation.
- *Transition* — The FASB received user feedback that, for transitions to newly promulgated standards, retrospective application at the beginning of fiscal years provides the most useful information to financial statement users. Therefore, in evaluating transition alternatives for new standards, the FASB will first examine the difficulty in and usefulness of applying retrospective application. If retrospective application does not appear appropriate, the staff will then evaluate whether transition should be prospective or occur through a cumulative-effect adjustment. Mr. Golden stated that constituents should expect more retrospective application to be required in new standards in the future.

FASB Projects (Including Joint Projects With the IASB)

Messrs. Crooch and Golden discussed current FASB projects, as well as joint projects with the IASB. A complete list of projects with their updates is available on the FASB's Web site. Mr. Golden discussed some specific issues concerning the derivative disclosures project and the shortcut method project. The following are highlights of this discussion:

- *Derivative disclosures* — In addition to enhancing the disclosure requirements for derivative instruments, the final standard will encourage, but not require, companies that manage risk by using nonderivative instruments or activities to disclose how they use such items. A final standard is expected in the first quarter of 2008 to be effective for fiscal years beginning after November 15, 2008.
- *Shortcut method* — The shortcut method likely will be eliminated under a Statement 133 project (hedging) that is not expected to be completed until the middle of 2008. This timing is problematic because, under Statement 157, certain derivatives will not have a fair value of zero at inception because of bid-ask differences and therefore would not be eligible for today's shortcut method. The Board is expected to discuss whether it should address this issue in the short term by issuing previously proposed Statement 133 Implementation Issue E23.

EITF Activities

Mr. Golden discussed two consensuses, one consensus-for-exposure, and one other Issue on which he was hopeful a tentative conclusion could be reached in the near future. The two consensuses and the one consensus-for-exposure are, respectively:

- EITF Issue No. 07-1, "Accounting for Collaborative Arrangements."
- EITF Issue No. 07-6, "Accounting for the Sale of Real Estate Subject to the Requirements of FASB Statement No. 66, *Accounting for Sales of Real Estate*, When the Agreement Includes a Buy-Sell Clause."
- EITF consensus-for-exposure on Issue No. 07-4, "Application of the Two-Class Method Under FASB Statement No. 128, *Earnings per Share*, to Master Limited Partnerships."

A fourth EITF Issue that will be discussed at the March 2008 EITF meeting relates to the definition of what qualifies as "indexed to a company's own stock" to meet a scope exception provided in Statement 133. Mr. Golden hopes a tentative conclusion can be reached at the March meeting.

At its December 12, 2007, meeting the FASB ratified the two consensuses and approved the consensus-for-exposure.

Editor's Note: See Deloitte & Touche LLP's November 2007 *EITF Snapshot* for additional information on the EITF issues described above.

FASB Codification Project

Mr. Hoey discussed the current status of the FASB's codification project. The project is not intended to change U.S. GAAP, but rather create a single, online real-time database that includes all authoritative U.S. GAAP. In early 2008, the FASB plans to release the first version of the codification project for a one-year verification period during which the content will be available for free. The FASB encourages comments on the codification during the verification period. The FASB will require its use in 2009.

Panel Discussion on Fair Value and Valuation by:

Greg Franceschi, *Managing Director,* Duff & Phelps

Chester Spatt, *Mellon Bank Professor of Finance*, Tepper School of Business at Carnegie Mellon University

Michael Tully, *Practice Fellow*, Financial Accounting Standards Board

Topics Covered	Affects
• Fair value measurements • FASB Valuation Resource Group • Defensive value • Valuation models	Entities with assets and liabilities measured at fair value

Fair Value Measurements

To provide context for the discussion on fair value and valuation, Mr. Tully gave a brief overview of the requirements of Statement 157. The overview focused on the definition of fair value, the partial one-year deferral for nonfinancial assets and nonfinancial liabilities with nonrecurring fair value measurements, and the three-level hierarchy for inputs.

Editor's Note: See Deloitte & Touche LLP's September 27, 2006, *Heads Up* for more information on Statement 157 and fair value measurements.

Mr. Tully commented that preparers found the implementation of Statement 157 to be more complex than anticipated. To date, three FASB Staff Positions addressing Statement 157 implementation issues have been exposed (or are expected to be exposed shortly):

- Proposed FSP FAS 157-a amends Statement 157 to exclude Statement 13 and its related interpretive accounting pronouncements that address leasing transactions. The FASB has issued an Exposure Draft for comment.
- Proposed FSP FAS 157-b delays the effective date of Statement 157 for all nonfinancial assets and nonfinancial liabilities, except those recognized or disclosed at fair value in the financial statements on an annual or more frequently recurring basis. The FASB has issued an Exposure Draft for comment.
- A proposed FSP that clarifies how to measure liabilities at fair value under Statement 157. An Exposure Draft is expected to be issued shortly.

Mr. Tully referred to certain issues that the FASB discussed at Board meetings but decided not to add to its standard-setting agenda:

- Statement 157 disclosures are not required for the pension plan assets in the plan sponsor's financial statements. The FASB staff may look into what disclosures would be useful for these statements.
- Questions have been raised about what the appropriate methods are for valuing whole loans that a company may securitize. Mr. Tully stated that some Board members believe that when observable prices exist for whole loans, fair value should be based on those prices. In contrast, if no market exists for whole loans, it may be appropriate to use price information in the securitization market, adjusted for anticipated costs (e.g., transformation costs) and profit margin, in valuing the whole loans.

Editor's Note: In another speech, Mr. Russell Golden stated that certain Board members believe that companies should "value what they **have**, not what they **will have**" — the implication being that if the whole loan is not yet securitized, companies should not use a securitization price. However, he also stated that if a company believes that it should value what it "will have," it should make adjustments for anticipated costs and profit. As noted by both FASB staff members, there is currently diversity in practice on this issue. Because the Board decided not to address the issue, we believe that reasoned judgment is appropriate on this matter.

FASB Valuation Resource Group

In early 2007, the FASB issued an Invitation to Comment requesting, among other things, constituents' feedback on whether the FASB should provide valuation guidance. On the basis of the feedback it received, the FASB formed the Valuation Resource Group in July 2007. The VRG is a **nonauthoritative** body (i.e., no formal minutes are produced) consisting of valuation professionals, accounting experts, preparers, users, and regulators. The group discusses differences in the ways companies perform fair value measurements. To date, 15–20 different issues have been discussed at VRG meetings, some of which have been presented to the Board for consideration.

Mr. Tully touched on the following issues discussed by the VRG:

- *Determination of market participants (such as assets or entities acquired in an auction)* — The VRG believes that an entity is not precluded from using its own transaction price in determining fair value in an auction scenario, in the absence of indicators to the contrary (e.g., indicators in paragraph 17 of Statement 157).
- *Use of net asset value to measure certain investments* — Many VRG members believe that net asset value may be an appropriate starting point for determining the fair value of certain investments, such as private equity funds. However, in a manner consistent with the fair value framework, the entity needs to consider whether any other adjustments are warranted (e.g., for restrictions that are an attribute of the investment).
- *Highest and best use (land example)* — When land that includes property improvements is determined to have a highest and best use as vacant land, questions arise about how value assigned to the real estate should be allocated to land and improvements. Most VRG members agreed that no value should be assigned to the property improvements in this situation, which reflects the valuation premise that the highest and best use of the property would be as vacant land.
- *Definition of "significant" in reference to level 2 adjustments* — The term "significant" will not be defined further since that would be more "rules-based" than "principles-based." Reasonable judgment should be used in determining significance.

Mr. Tully added that in future meetings the VRG would probably focus more on nonfinancial issues, including the valuation of assets in a business combination and intangible assets (e.g., customer relationships).

Editor's Note: A complete list of the issues discussed by the VRG is available on the FASB's Web site

Defensive Value

Mr. Franceschi discussed the concept of defensive value. Defensive value is derived when an entity locks up or shelves an asset even though the asset would be expected to have value to a market participant. This can happen when an asset is acquired in a business combination and the acquiring entity does not intend to use the asset in its existing business. Instead, it intends to shelve it in a defensive move to keep it from being used by a competitor, thereby enhancing the value of the entity's own assets. For example, a market participant might be willing to pay something for a locked-up asset, such as a trademark. Mr. Franceschi added that he believes that when an entity has defensive assets, these assets generally have a finite life and the amortization pattern would most likely follow that of the expected benefit the asset provides the entity (e.g., expected decline in value). The VRG will continue to discuss the appropriate treatment of defensive value at future meetings and may present this issue to the Board if warranted.

Valuation Models

Mr. Franceschi also discussed the process for allocating the purchase price to assets and liabilities acquired in a business combination under Statement 141. He noted that it is important to understand the basis for the price paid and the inputs used to support the buyer's purchase price. This "business enterprise valuation" is the starting point for all other valuations and allocations in that business combination, in the absence of observable data to the contrary.

Mr. Spatt discussed different aspects of valuation, including different types of models, as well as some of the implementation challenges and biases in the valuation process. Some of his key points were:

- There are several different types of valuation models available for valuing financial assets and liabilities.
- It is important to ensure that the model used is based on "reasonable" choices; otherwise, the model may not provide appropriate valuations.

- Valuation and risk are intertwined. In the valuation of an asset, ensuring that the appropriate risk premium is used as an input in the model is critical to arriving at appropriate valuations.
- An appropriate valuation is based on the best use of the asset.
- Judgment is critical in selecting models and parameters. Evaluate judgments made by management and be sensitive to management biases.
- Entry and exit prices may be different because of implicit transaction and evaluation costs.

Speech by Stephanie L. Hunsaker, *Associate Chief Accountant*, Division of Corporation Finance of the Securities and Exchange Commission

Topics Covered	Affects
• Presentation of a change from consolidation to equity method accounting	Entities with investments in subsidiaries
• Management's Discussion and Analysis in the current credit environment	Registrants with exposure to the conditions of the current credit market

Presentation of a Change From Consolidation to Equity Method Accounting

Ms. Hunsaker discussed the appropriate financial statement presentation for a change in accounting for an investment in an entity from consolidation to the equity method of accounting. Before the effective date of Statement 144, the SEC staff did not object to retroactive presentation of the investment and its results under the equity method as of the beginning of the fiscal year, as long as the events resulting in deconsolidation occurred during that fiscal year. The basis for this view was paragraph 12 of ARB 51, which stated:

> When the investment in a subsidiary is disposed of during the year, it may be preferable to omit the details of operations of the subsidiary from the consolidated income statement, and to show the equity of the parent in the earnings of the subsidiary prior to disposal as a separate line item in the statement.

However, paragraph C2(b) of Statement 144 deleted paragraph 12 of ARB 51. Therefore, it is no longer appropriate for an investor to retroactively apply the equity method to the beginning of the fiscal year. Instead, an investor must apply the equity method prospectively from the date control over the investee is relinquished (i.e., the date consolidation is no longer appropriate).

Example

A calendar-year-end registrant, acting as a general partner to a limited partnership, has historically consolidated the limited partnership through its exercise of control. However, on August 31, 2007, the general partner granted the limited partners substantive kickout rights; thus, the general partner concluded that it no longer exercises control. The general partner is required to present the change in accounting from consolidation to the equity method prospectively, beginning on August 31, 2007.

According to Ms. Hunsaker, improperly presenting the deconsolidation of an investment through retroactive application to the beginning of the fiscal year is an error and must be evaluated for materiality. She added that although correction of the error would not affect the registrant's net income, earnings per share, or total increases or decreases in cash and cash equivalents in the statement of cash flows, individual income statement or cash flow statement line items could be significantly affected and must be considered in the materiality analysis.

Management's Discussion and Analysis in the Current Credit Environment

Finally, Ms. Hunsaker discussed the current credit markets and related disclosures registrants should consider in preparing the MD&A section of their annual filings. Given the current credit environment, in which entities are experiencing increasing loan loss allowances, write-downs and impairments of securities, credit downgrades, dividend reductions, and liquidation of collateralized debt obligations (CDOs) or structured investment vehicles (SIVs), Ms. Hunsaker remarked that it is critical to provide investors with enough information about the registrant's (1) subprime exposure, (2) off-balance-sheet risks, (3) structures that could become consolidated, and (4) exposure to investments without readily determinable values.

Editor's Note: The SEC's Division of Corporation Finance has also issued a sample letter to public companies that have investments in SIVs, Conduits, and CDOs. The letter highlights similar disclosure issues for registrants to consider in preparing their MD&A disclosure in their upcoming Forms 10-K.

Ms. Hunsaker noted that the SEC staff reviewed disclosures of several registrants affected by the current credit environment and observed expanded disclosures regarding (1) off-balance sheet section of MD&A, (2) critical accounting estimates section of MD&A, (3) fair value measurements, (4) change in fair value inputs, and (5) Interpretation 46(R) disclosure. She made the following observations about items potentially affected by the current credit environment:

Off-balance-sheet section of MD&A — Item 303 of Regulation S-K requires a discussion of off-balance-sheet arrangements, including information that the registrant believes investors must understand concerning the effects of these arrangements. Registrants with a material exposure to asset-backed commercial paper conduits, CDOs, and SIVs should consider disclosing details in MD&A, including:

- The categories, ratings, and weighted-average life of assets held.
- The forms of funding and weighted-average life of the funding.
- A description of difficulties experienced in issuing commercial paper or other forms of financing during the period.
- Whether any write-downs or downgrades of assets were recognized.
- The maximum limit of losses to be borne by first-loss noteholders.
- Types of variable interests held.
- Whether the registrant purchased commercial paper or other securities issued by off-balance-sheet entities managed by the entity, and whether those purchases were required under any agreement.
- Obligations under any existing liquidity facilities or written put options, including:
  - Triggers associated with the obligation to fund.
  - Terms that would limit the obligation to perform.
  - The nature of the obligation under the facilities (e.g., any requirement to purchase assets from a variable interest entity and the purchase price, or any requirement to purchase commercial paper or other securities).
  - Existence of other liquidity providers and the order of priority.
- Whether the registrant provided any other type of support, or expects to do so in the future.
- The potential impact on debt covenants, capital ratios, credit ratings, and collateral requirements or dividends, should consolidation of the off-balance-sheet entity be required or significant losses be incurred.

These disclosures should provide insight into the quality of the assets held in the off-balance-sheet entities and the exposure to liquidity risk.

Critical accounting estimates section of MD&A — The SEC staff suggests that registrants consider disclosing the following in MD&A (this particularly applies to entities that have previously identified as a critical accounting policy the primary beneficiary evaluation under Interpretation 46(R)):

- The types of scenarios in which a registrant would have to consolidate the off-balance-sheet entity and the likelihood of such an event.
- How frequently the registrant reconsiders whether it is the primary beneficiary of the entity, and the typical events that would require reconsideration.

The SEC staff also suggests disclosure of the amount of loss a registrant expects to realize for its involvement with the off-balance sheet entity. This disclosure is consistent with the requirement under Item 303 of Regulation S-K to disclose any known trends or certainties that are reasonably expected to have a material impact on income, liquidity, or capital resources.

Each registrant, on the basis of its own facts and circumstances, should determine the best way to present this information. Ms. Hunsaker noted that the information can be aggregated to the extent that it is comparable among material off-balance-sheet entities.

Fair value measurements — Another area of focus is the determination of fair value for securities affected by the current credit market conditions. The SEC staff believes that many registrants do not provide enough insight into how they determine fair value.

Example

Such a disclosure as "the valuation of financial instruments becomes more subjective and involves a higher degree of judgment when market data is not available" is not very insightful.

When market data are not available, and the registrant has a material amount of financial instruments measured at fair value, the SEC staff believes that registrants should consider disclosing the following:

- The types of models used in these situations.
- The significant inputs into the models.
- The assumptions that could have the greatest impact on the valuation.
- Whether, how, and why those assumptions have changed from prior periods.

The SEC staff is not suggesting that this type of disclosure be provided for every financial instrument; rather, the focus should be on those financial instruments whose valuations have the most significant impact on a company's results of operations, liquidity, or capital resources.

Change in fair value inputs — Another topic associated with the current credit environment concerns registrants that have early adopted Statement 157. Because of current market conditions, such registrants have concluded that certain assets or liabilities no longer should be considered Level 2 instruments but have declined to Level 3 because of the lack of market-observable inputs. To the extent that there are material reclassifications between the levels of the fair value hierarchy, the SEC staff believes that a registrant should consider disclosing not only the types of instruments that are reclassified but also the nature of the inputs that are no longer readily observable.

Example

Instead of limiting its disclosure to "$X amount of U.S. subprime residential mortgage-related assets and asset-backed security CDOs was transferred to Level 3 because of a decrease in the observability of market prices for these instruments," a registrant should consider outlining the specific market inputs that are no longer observable. The registrant may also need to discuss how it determines the fair value of these instruments, given the lack of observable market inputs, including descriptions of the key assumptions used.

Interpretation 46(R) disclosure — The final topic concerns a disclosure under Interpretation 46(R) that requires a variable interest holder to disclose its maximum exposure to loss. Ms. Hunsaker noted that it is sometimes difficult to determine what is included in that amount and which agreements were considered.

The SEC staff suggests expanding this disclosure to identify what the maximum loss amount includes, such as unfunded liquidity commitments and other contractual guarantees, and to quantify the maximum exposure for each component. Registrants should also consider describing what events would need to occur for the maximum loss amount to be incurred.

Speech by Sandie E. Kim, *Professional Accounting Fellow*, Office of the Chief Accountant of the Securities and Exchange Commission

Topics Covered	Affects
• Revenue recognition for hardware deliverables in software arrangements	Entities that enter into arrangements within the scope of SOP 97-2 that contain hardware deliverables
• Fair value	
• Intangible assets and the use of a replacement cost approach	Entities that value intangible assets
• Discounts and share-based payment arrangements	Entities that issue share-based payment arrangements
• Interaction of the fair value option with nonfinancial performance obligations	Entities electing the fair value option
• Simplified method of calculating expected term for share options	Entities that issue share options

Revenue Recognition for Hardware Deliverables in Software Arrangements

Ms. Kim pointed out that as a result of "exponential advances in technology," more and more hardware deliverables are being included in the scope of SOP 97-2. Applying SOP 97-2 to multiple units of hardware delivered over a long period can be difficult, especially when vendor-specific objective evidence of fair value does not exist for the hardware. Ms. Kim noted that SOP 97-2 appears to require deferral of all revenue in such arrangements until VSOE is established or all hardware elements are delivered. However, Ms. Kim explained that SOP 97-2 "does contain exceptions to the general rule on revenue deferral," specifically cases in which the only undelivered elements are postcontract customer support or certain services. This would allow for proportional recognition of revenue for multiple units of hardware delivered over a period in which VSOE of fair value does not exist for the hardware. Such accounting would be similar to ratable recognition of a fee over a PCS period or over a period during which services are expected to be performed.

Ms. Kim also emphasized that when the only undelivered elements in a software arrangement are PCS and services, in practice, recognition of the entire fee is allowed over the longer of the PCS or service period. She notes that the basis for this view is that there is "no inappropriate front-loading of revenue since revenue, including any significant discount that may be included in the arrangement, is recognized over the longest period of performance."

By analogy to PCS and services under SOP 97-2, Ms. Kim believes that a "reasonable application of the provisions of SOP 97-2 can result in proportionate recognition of revenue for hadware without VSOE of fair value if the remaining deliverables are multiple units of the same product." She used the following example to illustrate her point.

> [A] company has an arrangement in which the remaining deliverables are 100 units of Hardware Product A and 200 units of Hardware Product B. VSOE of fair value does not exist for either hardware product and both hardware products are in the scope of SOP 97-2. In this fact pattern, the staff would not object if revenue were recognized based on a consistent ratio of both products (that is, one unit of Product A for every two units of Product B).6 This methodology ensures that revenue is not prematurely recognized and that any discount in the arrangement is recognized proportionately.
>
> [6] Continuing on with the example, if four units of Product A were delivered at $10 per unit and four units of Product B were delivered at $15 per unit in a particular period, revenue would be limited to two units of Product A ($20) and four units of product B ($60). If instead, two units of Product A were delivered and six units of Product B were delivered, revenue would likewise be limited to two units of Product A ($20) and four units of Product B ($60).

Fair Value

Intangible Assets and the Use of a Replacement Cost Approach

Ms. Kim indicated that the staff is seeing "a lot of practice issues" concerning valuing intangible assets in a business combination, specifically using the replacement cost approach in valuing an intangible asset. Ms. Kim noted that when valuing intangibles, entities should ask the following question:

> Would a market participant pay a premium for the benefit of having the intangible asset available for use today, rather than waiting until the asset is obtained or created?

If the answer is yes, the staff "believe[s] that an 'opportunity cost' should be considered in the fair value of the intangible asset under a replacement cost approach." The opportunity cost would equal the forgone cash flows during the period it would take to create the asset compared with the cash flows that would be received if the intangible asset were on hand today.

Discounts and Share-Based Payment Arrangements

While Statement 157 does not apply to share-based payment arrangements, Ms. Kim noted that Statement 123(R) provides for the use of valuation and assumptions that are consistent with the fair value measurement objective. She explained that when valuing share-based payment arrangements, entities should use assumptions specific to the security rather than assumptions a "specific holder of the security would consider." This concept is similar to Statement 157's concept of the use of market participant assumptions or attributes that would transfer to the market participant. Ms. Kim gave the following examples to illustrate the staff's view on this topic:

Example in which reduction **is** appropriate

> For example, one common term we see in share-based payment arrangements is a restriction that prohibits the transfer or sale of securities. If the security contains such a restriction that continues after the requisite service period, that post-vesting restriction may be factored as a reduction in the value of the security. . . .

Example in which reduction **is not** appropriate

> For example, we have heard arguments that a significant discount should be taken on certain share-based payment awards because the securities were issued to a group of executives that were subject to higher taxes than other employees. The staff does not believe this assumption is consistent with a fair value measurement objective.

Ms. Kim wanted to remind entities that if a discount is appropriate, the use of "general rules of thumb" in determining the discount is not appropriate and that the calculation of any discount should be based on information specific to the security.

Interaction of the Fair Value Option With Nonfinancial Performance Obligations

Because of the issuance of Statement 159, entities need to carefully analyze items they elect to carry at fair value to ensure that they consider substantive nonfinancial performance obligations.

> **Editor's Note:** See Deloitte & Touche LLP's June 1, 2007, *Financial Reporting Alert* for additional information on election of the fair value option for equity interests or other financial instruments with a significant future-services component.

Ms. Kim points out that the existence of such an obligation highlights the need to consider the "interplay" between Statement 159 and other areas of GAAP, such as revenue recognition. In certain circumstances, measuring a financial interest at fair value may result in an inappropriate acceleration of revenue recognition. Ms. Kim used the following two examples to clarify her point.

> [A]n investor may have an equity interest in another entity that is accounted for under the equity method. That equity interest may also have an embedded feature that provides the investor with a disproportionate allocation of returns. This scenario often occurs in certain partnership agreements, in which the general partner's interest includes an embedded feature commonly known as a "carried interest." If the general partner measured its investment at fair value, the carried interest might be included in that measurement. However, if the general partner's investment includes a substantive performance obligation to the equity method investee,

such as management services, the carried interest may represent compensation for services to be performed. If so, measuring the investment at fair value may result in a gain recognized for profits associated with future performance obligations.

[A] company may have a recognized receivable related to a customer arrangement that also includes a variable fee component related to future performance obligations. In that example, the company may have recognized a receivable related to services already performed. However, the variable fees may not have been recognized because the appropriate revenue recognition criteria were not met.

In these scenarios and others, until the FASB addresses the fair value option for items that are not currently eligible under Statement 159, the staff believes careful consideration is required to determine whether the fair value option under Statement 159 is even available.

Simplified Method of Calculating Expected Term for Share Options

Ms. Kim discussed the use of the "simplified method" in determining the expected term of "plain vanilla"[6] options. The simplified method, as discussed in SAB 107, allows an entity to calculate the expected term of share-based awards by simply averaging the vesting term and the original contract term. SAB 107 allows for the use of the simplified method through December 31, 2007. Ms. Kim indicated that "based upon information available at the time SAB 107 was issued, the staff believed that more detailed external information about exercise behavior . . . would, over time, become readily available to companies." Ms. Kim acknowledged that such detailed external information has not become widely available since the issuance of SAB 107; as a result, entities may still struggle in trying to determine an appropriate expected term for share-based payment awards. Consequently, Ms. Kim said entities should "stay tuned," since the SEC staff is considering additional guidance on applying the simplified method.

[6] SAB Topic 14 (SAB 107) describes a plain vanilla award as an award with the following basic characteristics: (1) share options are granted at-the-money; (2) exercisability is conditional only on performing service through the vesting date (i.e., the requisite service period equals the vesting period); (3) if an employee terminates service before vesting, the employee would forfeit the share options; (4) if an employee terminates service after vesting, the employee would have limited time to exercise the share options (typically 30 to 90 days); and (5) the share options are nontransferable and nonhedgeable.

Speech by James L. Kroeker, *Deputy Chief Accountant*, Office of the Chief Accountant of the Securities and Exchange Commission

Topics Covered	Affects
• Confidence in making accounting decisions • Authority of SEC staff remarks	Preparers and auditors of financial statements
• Subprime loan developments	Lenders with on-balance-sheet subprime loans or loan servicers of subprime loans sold to qualifying special-purpose entities

Confidence in Making Accounting Decisions

Recognizing the challenging decisions faced daily in the profession, Mr. Kroeker shared the following thoughts on how accountants might increase their level of confidence in making those decisions.

- *Completely understand the terms and economics of the transaction or arrangement.* Consider what rights are created, what obligations are incurred, and the nature of each party's risks and rewards. Mr. Kroeker cited the example of liquidity support arrangements related to investment vehicles that "would otherwise be off-balance-sheet," stating that it is important to understand all of the arrangement's terms in deciding whether a vehicle should be accounted for under Interpretation 45, Interpretation 46(R), or another accounting model.
- *Involve those with relevant experience and knowledge before accounting for the transaction.* It is important to obtain unbiased perspectives by consulting with unbiased, knowledgeable individuals. That is, consider advice on accurately accounting for a transaction's economic substance rather than advice on structuring an arrangement to achieve a particular accounting objective. Also, consider the expertise of the persons performing and reviewing the judgments made.
- *Realize that there might not always be only one "right" answer.* Mr. Kroeker noted that accounting is "not a series of immutable truths" and that at times multiple accounting conclusions will be acceptable after reasonable judgment is applied. When applying judgment, accountants should consider whether the final accounting conclusion meets the objectives of the standards applied. Mr. Kroeker questioned rhetorically whether accountants or regulators are ready to accept this premise.

Mr. Kroeker also noted that when more than one conclusion is acceptable, transparent financial statement disclosures that describe how the accounting principles were applied and how decisions were made will help increase confidence in the way an accounting decision was reached. However, he cautioned that even good disclosure does not cure bad accounting.

Authority of SEC Staff Remarks

Mr. Kroeker noted that speeches made at this conference and in other venues may have been mischaracterized as authoritative guidance or as providing the "one right answer." Echoing Chief Accountant Hewitt's sentiments, Mr. Kroeker noted that conference speeches are meant to help preparers and auditors gain insight on improving or confirming a company's accounting. They are not meant to set authoritative guidance, but rather to present sets of facts illustrating the SEC's views on applying existing standards. The speeches are also meant to guide practitioners on the appropriate accounting standards to use. If a registrant has questions about its particular situation in relation to remarks made, and about whether a different view is acceptable, the registrant should discuss its views with the SEC staff.

Subprime Loan Developments

In a question-and-answer session, Mr. Kroeker addressed inquiries about the accounting implications of recent developments related to subprime mortgage loans.

On December 6, 2007, President Bush outlined a voluntary plan, developed by lenders and securitizers, to streamline the process of loan modifications to provide relief to certain subprime borrowers. Questions have arisen about whether the plan precludes off-balance-sheet treatment under Statement 140 for assets held in securitization vehicles.

Mr. Kroeker noted that the concern is whether the plan's screening criteria for categorizing loans will, for the most part, appropriately identify only those loans whose default truly is "reasonably foreseeable." If not, qualified special-purpose entity status and off-balance-sheet treatment might be questioned. Mr. Kroeker also noted that because of the timing and nature of these recent developments, the SEC staff is continuing to think through the accounting implications. He stated that the SEC staff is willing to participate in an open dialogue on the matter.

Editor's Note: See "Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans" on the American Securitization Forum's Web site.

A related question involves companies that have loans recorded on the balance sheet. For them, would temporary relief in the form of a reduction of interest rates be considered a troubled debt restructuring under Statements 114 and 115? Mr. Kroeker indicated that he believes that the FASB also has received requests to provide guidance in this area, and until decisions are made for any additional guidance, he pointed preparers to the guidance already existing within these standards to form an accounting policy. He encouraged discussion with the SEC staff if further questions exist.

Speech by Robert C. Pozen, *Committee Chairman*, Advisory Committee on Improvements to Financial Reporting of the Securities and Exchange Commission

Topics Covered	Affects
• Update on activities of the SEC's Advisory Committee on Improvements to Financial Reporting (CIFiR)	Preparers, auditors, regulators, and users of financial statements

Mr. Pozen stated that the CIFiR will make recommendations to the SEC on how to reduce complexity in financial reporting for financial statement preparers and users. The CIFiR will work closely with the SEC and FASB to ensure timely implementation of the final recommendations, which Mr. Pozen expects to be issued in August 2008. Mr. Pozen expects the following eight recommendations to emerge from the CIFiR's deliberations:

1. Provide for "tiered annual reports" beginning with a high-level summary that links to more detailed data. This proposal would provide tailored information for both sophisticated and nonsophisticated users.
2. Develop a workable roadmap to XBRL implementation for both large and small public companies.
3. Reduce the number of restatements by eliminating those that do not have the potential to change the market value of a registrant.
4. Create a roadmap for registrants and auditors to deal with accounting issues (e.g., whether they should direct an accounting issue to the SEC's Division of Corporation Finance, the SEC's Office of the Chief Accountant, or the FASB).
5. Narrow GAAP to two sources: authoritative and nonauthoritative.
6. Create a rebuttable presumption that industry-specific guidance is unnecessary; change the focus to business activities.
7. Create accounting and auditing standards that allow for increased use of judgment among preparers and auditors (e.g., eliminate bright lines in accounting standards).
8. Reorganize and clarify financial statements by distinguishing between core earnings and other items that are important for users, such as unrealized gains and losses.

Editor's Note: Although a final report of the CIFiR's recommendations is not expected until August 2008, Mr. Pozen indicated at a November CIFiR meeting that an interim report may be issued in early 2008.

Framework for Professional Judgment

According to Mr. Pozen, any set of CIFiR recommendations will require the increased use of judgment by preparers and auditors. He acknowledged that preparers and auditors will be reluctant to exercise judgment if they fear being second-guessed by the regulators. He proposed the idea, perhaps for PCAOB and SEC consideration, of a framework for professional judgment. This framework would help auditors substantiate their professional judgment to withstand regulatory or judicial scrutiny. The framework calls for auditors to (1) determine acceptable accounting approaches, (2) choose an approach and explain why this choice was appropriate, and (3) document this approach at the time the judgment is made. In response to a question, Mr. Pozen noted that while CIFiR is not focused on auditor liability issues, the framework could indirectly prove beneficial in this regard.

CIFiR Subcommittees

Five CIFiR subcommittees are developing the above recommendations. Mr. Pozen provided background information on each of these subcommittees and indicated their progress to date:

1. *Audit and Compliance* — This subcommittee focuses on identifying the causes of restatements. (Mr. Pozen remarked that in 2006, approximately 10 percent of all companies had to restate their financial statements.) He asserted that the primary cause of restatements concerns the definition of materiality and advocated reconsidering SAB 99, which may overemphasize the importance of quantitatively small errors. He argued that focusing materiality on the needs of current investors would help reduce the number of restatements that do not have a market impact. Another factor

contributing to restatements is misinterpretation of certain speeches, such as those from the SEC, as authoritative accounting guidance. Mr. Pozen supports excluding these speeches from the FASB's codification project.

2. *Substantive Complexity* — This subcommittee is considering the root causes of complexity. Mr. Pozen cited the following contributing factors to complexity in financial reporting: (1) industry-specific guidance, (2) bright lines in accounting standards, and (3) companies' predisposition to accounting rules designed to mitigate volatility in earnings.
3. *Delivery of Financial Information* — This subcommittee is examining ways to deliver more useful and relevant information to investors. Mr. Pozen noted that this subcommittee is focusing on the use of summary financial reporting and XBRL, including whether XBRL should be mandatory or optional. Mr. Pozen favors an extended path to mandatory adoption for all companies, with careful consideration given to smaller companies. This subcommittee will also consider the level of auditor assurance that should be required with respect to XBRL taxonomies.
4. *Standard Setting* — This subcommittee is examining how to improve the current standard-setting process, including (1) whether to establish a formal dispute mechanism for accounting matters at the SEC, (2) whether all authoritative accounting guidance should be subject to due process (e.g., SEC Staff Accounting Bulletins are not exposed for public comment), (3) formal designation of guidance by accounting firms as nonauthoritative, and (4) a one- to two-year period for implementing new accounting standards. During this one- to two-year period, as insights into the new standard are obtained, the consequences of divergent application would be relaxed, reducing the volume of restatements.

Editor's Note: James Quigley, chief executive officer, Deloitte Touche Tohmatsu, is a member of the Standard Setting subcommittee.

5. *International* — This subcommittee will focus on the steps for international convergence, but has not started its work since it is still waiting for the SEC to decide whether to allow U.S. registrants to adopt IFRSs. Areas the subcommittee will consider include governance, oversight (i.e., regulation), and fundamental aspects of convergence (e.g., education, training of professionals, certification).

Speech by Eric C. West, *Associate Chief Accountant*, Office of the Chief Accountant of the Securities and Exchange Commission

Topics Covered	Affects
• Accounting for litigation settlements	Companies involved with litigation settlements
• Interpretation 45 guarantees in a spin-off transaction	Parent companies and subsidiaries that retain guarantees after a spin-off
• Determining the acquirer in a business combination under Statement 141	Companies that acquire businesses

Accounting for Litigation Settlements

After acknowledging that the guidance on accounting for litigation settlements has not changed recently, Mr. West gave his insights on the following commonly encountered issues:

- Accounting for litigation settlements with multiple elements.
- Classification of the litigation settlement.
- Accounting for litigation settlements received from a vendor.

Accounting for Litigation Settlements With Multiple Elements

Mr. West emphasized that in accounting for complex litigation settlements with multiple elements, defendants should first itemize all items given and received as part of the settlement to determine which ones should be recognized. Generally, the defendant will make a cash payment to the plaintiff and recognize a portion of this payment as litigation settlement expense. Sometimes, however, the defendant may also **convey** certain licenses to the plaintiff or **receive** rights that qualify for separate recognition as intangible assets, effectively reducing the amount recognized as litigation settlement expense.

Mr. West cautioned that not all elements of a litigation settlement may qualify for recognition as intangible assets and that defendants should use judgment in making this determination. Mr. West stated that to meet the definition of an asset, covenants not to sue need to identify which trade secrets a company may have infringed upon or convey a right to use the trade secrets. For instance, a defendant obtaining a plaintiff's agreement not to sue would need to demonstrate that the covenant not to sue meets the definition of an asset and has value to a marketplace participant. If the agreement not to sue relates to an infringement of a trade secret and the right to use the trade secret could have been obtained legally in the marketplace, the covenant not to sue may not meet the definition of an asset (or may have no value). Furthermore, for the rights received to be considered an intangible asset, when a defendant receives a license to use a patent or trade secret, the defendant would need to demonstrate that it holds exclusive rights *or* has the ability to sell or transfer the rights. Should these characteristics not exist, the payment for the rights may be more akin to a prepaid royalty.

Example

Assume Plaintiff filed a lawsuit against Defendant alleging infringement on a trade secret. Plaintiff and Defendant resolved the dispute by entering into a binding legal settlement with the following terms: (1) Defendant will pay Plaintiff $100 million in cash for damages and convey certain licenses to Plaintiff, (2) Plaintiff will drop the lawsuit and provide a covenant to Defendant not to pursue future litigation regarding the trade secret, and (3) Plaintiff will give Defendant a new license agreement to use the trade secret in exchange for future royalty payments.

For Item (1), Defendant might recognize a litigation settlement expense for the cash payment and fair value of the licenses conveyed. If Plaintiff will use the licenses in its operations, it may be appropriate for Defendant to recognize revenue or income, instead of a gain, for the portion of the settlement related to the licenses (difference between fair value and book value of the licenses). Further, if certain criteria are met (as discussed above), Defendant may be able to recognize Items (2) and (3) as intangible assets, effectively reducing the amount recognized as litigation settlement expense.

Mr. West indicated that when assigning value to intangible assets received by a defendant (e.g., licenses), companies should analogize to the guidance in Issue 00-21. In other words, they should allocate the consideration paid to the plaintiff to the intangible assets and litigation component on the basis of their relative fair values. If the relative fair value of one element (e.g., litigation settlement component) cannot be determined, it may be acceptable for companies to use a residual value method. Reasonable judgment should always be applied with respect to the valuation methodologies and allocations.

Classification of the Litigation Settlement

Mr. West noted that a defendant's income statement classification of amounts recognized for a litigation settlement may depend on the relationship the defendant has with the plaintiff. When the defendant does not have a prior relationship with the plaintiff, it would be appropriate to recognize the litigation settlement as an operating expense. However, in cases in which the defendant settles a legal matter with a customer, as shown in the example below, classification of the full amount as an operating expense may not be appropriate.

Example

Customer accuses Vendor of billing in excess of the contracted price over the past five years. Customer and Vendor enter into a legal settlement in which Vendor agrees to pay Customer $5 million for actual overbillings *plus* an additional $3 million to induce the legal settlement and preserve the ongoing customer relationship.

Mr. West indicated that companies should consult Issue 01-9 when settling litigation with a customer to determine whether a portion of the excess payment (e.g., $3 million) should reduce revenues rather than be recorded as a component of operating expenses. In the example above, Vendor would need to determine what portion of the $3 million additional payment relates to (1) settling the litigation, which it would record in operating expenses, and (2) a payment to retain the customer, which it would record as a reduction in revenues. If Vendor cannot determine the fair value for each component of the excess payment, the entire excess payment should be recorded as a reduction of revenues in accordance with Issue 01-9.

Accounting for Litigation Settlements Received From a Vendor

Mr. West also touched on the plaintiff's accounting. He reminded companies that they should follow the guidance in Issue 02-16 when determining where in the income statement to record amounts received from a vendor in a litigation settlement. Thus, companies generally should record the settlement payments received from their vendors as reductions in cost of goods sold. Companies would only classify the payment received as a gain when the payment is clearly outside the vendor/customer relationship. To help users understand the judgments made, Mr. West emphasized that companies should always disclose the terms of the settlement and its classification.

Interpretation 45 Guarantees in a Spin-Off Transaction

Under the scope exception in paragraph 7 of Interpretation 45, companies are not required to recognize liabilities for guarantees (e.g., legal settlements, tax indemnities) between parents and subsidiaries. However, Mr. West reminded companies that this scope exception is no longer appropriate once a parent company spins off, and no longer consolidates, a subsidiary. In other words, if a guarantee remains in place after a spin-off, it should be treated as the issuance of a new guarantee and the paragraph 7 scope exception would no longer apply. Mr. West pointed out that some companies have misinterpreted this guidance by continuing to apply the scope exception after a spin-off.

Determining the Acquirer in a Business Combination Under Statement 141

Mr. West then addressed misconceptions about the SEC staff's views on determining the acquirer in a business combination when the minority shareholder controls the board for a short period.

Editor's Note: Statement 141 requires, as part of a business combination, that companies identify an acquiring entity. Paragraph 17 of Statement 141 lists criteria that companies should evaluate when determining the acquiring entity, including an evaluation of the board of directors of the combined entity (paragraph 17(c)). Such an evaluation may include how long board members are entitled to hold their positions and whether they represent the majority or minority shareholders of the combined entity.

For example, a minority shareholder may initially have control of the board of directors of a combined entity, but this control may only last for a short tenure (e.g., two years). Some companies may determine this minority shareholder's control to be temporary, and thus may determine the minority shareholder not to be the acquirer, while other companies may reach the opposite conclusion.

Mr. West clarified that the SEC staff does not have a bright-line test for determining whether control of a combined entity's board of directors is temporary. Rather, control of the board of directors should be "substantive," and companies should evaluate all relevant facts and circumstances before reaching any conclusions.

SEC MATTERS

Speeches by:

Wayne E. Carnall, *Chief Accountant*, Division of Corporation Finance of the Securities and Exchange Commission

Craig C. Olinger, *Deputy Chief Accountant*, Division of Corporation Finance of the Securities and Exchange Commission

Topics Covered	Affects
• Goals and objectives for the Division of Corporation Finance • Filing review statistics	SEC registrants

Goals and Objectives for the Division of Corporation Finance

After four days on the job, Mr. Carnall introduced himself to the attendees at the conference and discussed his goals and objectives for the Division of Corporation Finance and what to expect in the upcoming years. One of his highest priorities will be to help make interactions with the Division as efficient and effective as possible, including encouraging better communication among companies, auditors, and the Division staff. He will start with the presumption that registrants and accountants want to do what is right and will operate under that assumption until proven otherwise.

Mr. Carnall has serious concerns about the market implications of the large number of restatements (e.g., the delisting of foreign private issuers). He urged issuers not to "restate simply because you believe the staff will require a restatement." Instead, each company should confer with the SEC staff to determine whether, given the company's particular circumstances, restatement is appropriate.

Mr. Carnall noted that about 10 percent of U.S. companies restated their financial statements last year. Conversely, there were few, if any, restatements in Europe, although he acknowledged that there are regulatory and cultural differences between the two reporting systems. These differences will require more in-depth analysis as the United States moves closer to international convergence. In addition, Mr. Carnall discussed international goals, including increasing the number of foreign private issuers and addressing acceptance of IFRSs by U.S. companies.

Finally, Mr. Carnall hopes that under his leadership the Division will be viewed as "pragmatic, proactive, and responsive." He said that he would strive to ensure that all companies believe they have been treated fairly by the Division staff. In closing, he stated that he looks forward to working with companies and will reach out to the profession and other standard setters as needed.

In response to a question, Mr. Carnall discussed an SEC reporting issue that has arisen as a result of Statement 159. Under Statement 159, a registrant may elect the fair value option for its equity method investees. In such circumstances, a registrant should use the change in fair value (instead of the registrant's equity in earnings of the investee) in performing the income test of significance to determine whether separate financial statements or summarized financial information is required for an equity method investee.[7] While change in fair value may seem to be a logical proxy for income, this may be inconsistent with the requirements of the rules. The SEC staff will continue to consider this issue in the future.

Editor's Note: See Discussion Document F from the October 2007 SEC Regulations Committee meeting for the requirement to use the change in fair value reflected in the registrant's income statement to perform the income significance test.

[7] Under Rules 3-09 and 4-08 (g) of Regulation S-X.

Filing Review Statistics

Mr. Olinger gave an annual update of the number of reviews that the Division performed for the fiscal year ended September 30, 2007, in addition to other noteworthy statistics:

- The Division reviewed approximately 4,600 issuers, or 36 percent of all issuers (a slight increase over the previous year).
- Of the total reviews, 550 involved initial public offerings (down from 630 in fiscal year 2006).
- The average time between filing a registration statement and receiving initial comments was 25.5 days (down from 26.2 days in fiscal year 2006).

Speeches by:

Linda Chatman Thomsen, *Director*, Division of Enforcement of the Securities and Exchange Commission

Susan G. Markel, *Chief Accountant*, Division of Enforcement of the Securities and Exchange Commission

Walter G. Ricciardi, *Deputy Director*, Division of Enforcement of the Securities and Exchange Commission

Topics Covered	Affects
• Lessons learned from recent SEC enforcement actions involving municipal bond offerings • Current priorities in the Division of Enforcement	Public companies, municipalities, and their auditors

Lessons Learned From Recent SEC Enforcement Actions Involving Municipal Bond Offerings

Ms. Thomsen discussed recent actions taken by the Division of Enforcement on securities fraud in the City of San Diego's municipal bond offerings. Ms. Thomsen noted that if securities fraud can happen in offerings of a large city like San Diego, it can happen to any municipal bond issuer.

Editor's Note: Municipal markets have become an area of increased focus at the SEC, especially considering that outstanding municipal securities total more than $2.5 trillion. See SEC Chairman Christopher Cox's July 2007 speech regarding the importance of integrity in the municipal marketplace.

Ms. Thomsen enumerated five important practices, derived from the San Diego situation, that any company can apply:

- Adopt written policies and procedures to ensure proper internal control over financial reporting and disclosures.
- Provide training to employees on financial reporting and disclosure requirements.
- Issuers and auditors should focus on the big-picture issues to ensure full and fair disclosure to investors. Companies should not let a checklist mentality prevail. As a best practice, companies should consider team brainstorming sessions to identify issues first and subsequently decide what related information should be disclosed.
- Disclose the bad news as well as the good. If a company has large underfunded pension and health care obligations, it needs to provide appropriate disclosures about that to ensure that investors are not misled.
- Hire auditors with the skills and resources necessary to do their jobs.

Ms. Markel further emphasized the importance of hiring auditors with the appropriate skills and resources to conduct proper audits. She stated that auditors need to go "back to basics" in the planning, execution, and analysis of audits and be attentive to the possibility of financial fraud in financial reporting. Auditors should be familiar with the client's business, industry, and transactions.

Current Priorities in the Division of Enforcement

Mr. Ricciardi discussed current priorities in the Division of Enforcement and a new working group strategy for improving the effectiveness and efficiency of investigations. Members of the Division staff are assigned to one or more of the different working groups. Each group focuses on key issues in its area and shares information among members. Mr. Ricciardi discussed the following working groups:

- *Insider trading* — The insider trading world consists of sophisticated networks. The Division of Enforcement is bringing actions not only against individuals (and sometimes numerous individuals), but against employees, supervisors, and organizations. Mr. Ricciardi noted that employers need to ensure that they properly supervise individuals with access to nonpublic information.

- *Stock options backdating* — While this is still an area of focus, the Division of Enforcement currently has only 80 pending investigations (compared with over 160 at one time). Mr. Ricciardi noted that an assertion that "everyone else is doing it" is not a valid defense. In addition, he indicated that the Division of Enforcement will now notify companies when it finishes an investigation.
- *Subprime mortgage crisis* — Mr. Ricciardi compared the current situation to the savings and loan crisis of the 1980s. The Division of Enforcement currently has over 30 investigations in process and is currently determining whether wrongdoing has occurred. The investigations focus on the possible existence of fraud (i.e., whether fraudulent information may have played a role).
- *Municipal finance* — Mr. Ricciardi discussed this group's investigation of the City of San Diego's securities fraud, as noted above, and other related matters.

Finally, Mr. Ricciardi discussed the Division of Enforcement's focus on the Foreign Corrupt Practices Act. Attention has shifted to this area because of the sharp increase in violations (e.g., overseas bribery). Over the past nine years, the Division of Enforcement investigated only 15 cases. In the past year alone, however, it has investigated eight.

Speech by Mark Cheffers, *CEO*, Audit Analytics

Topics Covered	Affects
• Observations on SEC comment letter research	SEC registrants

Since the enactment of the Sarbanes-Oxley Act of 2002, the SEC staff must review all registrants, including foreign private issuers, at least once every three years. This has resulted in an increase in the number of SEC comment letters issued since that date. Commencing in 2004, the SEC has been publicly releasing all comment letters and registrant responses on its Web site. Mr. Cheffers gave a presentation on his company's research results of the publicly available comment letters issued by the SEC over the past three years.

Mr. Cheffers indicated that his firm's research identified several topics in comment letters on which recurring questions have been raised, including the following: revenue recognition, segment reporting, share-based payments, contingencies, intangibles, receivables, inventory, earnings per share, MD&A, and internal controls. He further noted that registrants can gain insights on accounting and disclosure matters that the SEC may deem to be significant to investors by monitoring the comment letters. Registrants can use this information to improve their overall disclosure.

Speeches by:

Linda L. Griggs, *Partner*, Morgan Lewis

Gary R. Kabureck, *Vice President and Chief Accounting Officer,* Xerox Corporation

Barry N. Summer, *Associate Director*, Division of Corporation Finance of the Securities and Exchange Commission

Topics Covered	Affects
• Executive compensation disclosure • Management's discussion and analysis	SEC registrants

Executive Compensation Disclosure

The SEC's Executive Compensation Review Process

Mr. Summer discussed the SEC's executive compensation review project. He indicated that the SEC staff, to help companies comply with the new executive compensation disclosure rules, sent out approximately 350 executive compensation comment letters, 300 on the same day. He noted that this is a fairly typical procedure when significant new rules are issued. He discussed common observations resulting from this review and described what the SEC staff expects to see in executive compensation disclosures.

Mr. Summer indicated that the SEC's comments requested compliance in future filings and did not request any amendments at this time. He mentioned that the staff has received approximately 97 percent of the comment letter responses. To date, the staff has processed approximately 75 percent of these responses, drafting either follow-up comments or a letter of completion.

Editor's Note: For more information on executive compensation disclosures, see Deloitte & Touche LLP's September 7, 2007, and October 16, 2007, *Heads Ups*.

Developing the CD&A

Mr. Kabureck explained the process Xerox uses to develop its Compensation Discussion and Analysis and some of the challenges with this process. He reinforced that CD&A should focus not only on what changed in the financial statements but also on **why** changes occurred and **how** decisions were made. He reminded participants that CD&A is covered by the same disclosure rules as the rest of Form 10-K.

In view of the significant volume and complexity of CD&A disclosures, Mr. Kabureck recommended establishing a separate CD&A disclosure subcommittee. He also suggested developing a subcommittee charter that would define roles, responsibilities, and other items. This could be important because of the sensitive information disclosed about the executive officers affected by these disclosures.

The Xerox CD&A subcommittee has a working group to provide support as well as analyses, reports, documentation, etc., which serve as the underlying basis for the disclosures. The certifying officers rely on the subcommittee and working group to accumulate and properly disclose accurate CD&A information. Xerox's certifying officers require representation from both the members of the subcommittee and various members of the working group regarding the completeness and accuracy of the information underlying the disclosures. The representation requirement is considered a fundamental function of their jobs.

Compensation Consultants

Ms. Griggs mentioned that disclosure about compensation consultants has received recent attention. Representative Henry Waxman, chairman of the House of Representatives Committee on Oversight and Government Reform, asked the Commission to conduct a study on disclosures about compensation consultants. The study raised concerns about the adequacy of these disclosures, possible conflicts of interests that may arise when a compensation consultant also performs other services for a company, and the relationship between CEO pay and the existence of conflicts of interest.

Editor's Note: The study is available on the Committee on Oversight and Government Reform's Web site.

Executive Compensation Trends and Confidential Treatment Reminder

Ms. Griggs described some trends related to perks. She has observed that fewer perks are being issued, probably because of the requirement to disclose them once they reach the $10,000 threshold. She also stated that underwriters have traditionally requested comfort on information found in proxy statements. As a result, members of management and accountants who previously had limited exposure to executive compensation disclosures may become increasingly involved with this information.

Ms. Griggs reminded companies that in their letters in response to the SEC's comments, they should request confidential treatment when disclosing that performance targets or other information would provide competitive harm.

Management's Discussion and Analysis

Mr. Kabureck presented the process Xerox uses to develop its MD&A disclosure. He emphasized the need for financial statement readers, like management, to understand the causes and effects of changes in the financial statements.

Ms. Griggs added that she has noticed that many companies only include a liquidity and capital resources discussion in MD&A as of the balance sheet date. Companies should also disclose any significant developments in liquidity or capital resources that occurred after year-end.

She also reminded preparers to focus, in MD&A, on recent economic conditions and their impact. In addition, companies should review their discussion and analysis of critical accounting policies to ensure that they include information about the underlying significant assumptions and judgments used in developing the estimates, including sensitivity analyses. Companies should provide quantitative information in their sensitivity analyses and should analyze the accuracy of past assumptions used. These areas have been a recent focus of SEC comment letters.

Speech by Todd E. Hardiman, *Associate Chief Accountant,* Division of Corporation Finance of the Securities and Exchange Commission

Topics Covered	Affects
• Materiality and large errors	SEC registrants and auditors
• Judgment and the Division of Corporation Finance review process	SEC registrants
• Appeals process	

Materiality and Large Errors

At last year's conference, Mr. Hardiman discussed materiality and addressed the question "Can large errors be immaterial?" He indicated that while it is possible for large errors to be immaterial, the SEC staff did not often see this. He noted that the staff had only identified two examples in which a large error was immaterial — break-even years and discontinued operations.

Editor's Note: See Deloitte & Touche LLP's December 21, 2006, *Heads Up* for additional information.

At this year's conference, Mr. Hardiman noted that on the basis of those two examples, many left last year's conference believing that the staff only assesses materiality quantitatively. Mr. Hardiman explained that this was not his intent. **He took this opportunity to restate his position that large errors can be immaterial and discuss his views on "the qualitative factors that can cause a large error to be immaterial."**

Mr. Hardiman noted that the Supreme Court has held the following:

> A fact is material if there is a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

He noted that accountants have historically defined the "total mix" of information in two parts — quantitative and qualitative. Typically, accountants bring a quantitative bias to a materiality analysis, and if all else is equal, a large error is more important than a small error. In SAB 99, the staff provided a framework under which large errors were still material but small errors needed further qualitative evaluation. This resulted in circumstances in which qualitative factors could cause small errors to be material.

Mr. Hardiman then asked whether qualitative factors can also cause large errors to be not material. His answer was yes. However, when registrants provided analyses suggesting that a large error was not material, the primary support cited was typically the *absence* of the qualitative factors indicating that a small error is material. Mr. Hardiman believes that this approach is incomplete since the analyses neither addressed the significant size of the error nor discussed *why* the error would not be important to investors. The analysis would also need to include the qualitative factors *supporting* the assertion that the error is not important to investors despite its significant size.

Mr. Hardiman then addressed the qualitative factors that can cause a large error to be immaterial. While he indicated that there is no universal list of factors (since they will depend on a registrant's unique facts and circumstances), he believes registrants need to look to the view of the Supreme Court and focus on what is important to the reasonable investor. **He stated the need to address the question "Is there a substantial likelihood that the size of the error would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available?"** He indicated that company management should consider its own investors and the factors that are important to them by asking the following questions:

> Why doesn't the size of the error matter to the reasonable investor?
>
> What qualitative factors exist that make the size of the error unimportant to the reasonable investor?

Mr. Hardiman concluded that, while this may be a high hurdle, given the right facts and circumstances, a large error could be considered immaterial for qualitative reasons. He also indicated that registrants should not assume how the staff will view the materiality analysis. If a registrant believes a large error is not material, it should consult with the staff.

Judgment and the Division of Corporation Finance Review Process

Mr. Hardiman noted that the staff has heard recent criticism that "well-founded judgments are irrelevant to the Division's staff" — a criticism that the staff takes very seriously because reasonable judgment is the foundation of the financial reporting system.

He indicated that not all types of judgment are the same and discussed three distinct areas in which judgment is important:

1. Rules-based standards, which rely on exceptions and bright lines.
2. Objectives-oriented standards, which are more reliant on principles and subjective analysis.
3. Transactions to which the literature does not specifically apply.

The level of judgment the staff is willing to accept could depend on which areas of judgment the staff is focusing on.

Mr. Hardiman believes that management is generally in the best position to make judgments about its company's specific facts and circumstances. At times, however, the related disclosures do not adequately explain important judgments or they seem inconsistent with the exercise of appropriate judgment. Under these circumstances, the staff will question a registrant's judgment. Mr. Hardiman indicated that the staff questions judgments when:

- "The basis for an important judgment is counterintuitive or unclear from the disclosure,
- The judgments that are disclosed appear to be inconsistent with other judgments or assumptions made by management, or
- The analogy to accounting literature management cites to support a judgment has been superseded by more recent thinking and other more closely analogous accounting literature that existed at the filing date."

Mr. Hardiman emphasized that just because the staff is asking questions about a judgment does not mean that the staff believes the judgment is wrong. The staff asks these questions because its knowledge is limited to the company's disclosures, and the registrant needs to assist the staff in better understanding why certain judgments were made. He also asked that registrants fully participate in the dialogue. By accepting the staff's conclusion, a registrant validates the comment. This may lead the staff to conclude that the registrant agrees with its position when, in fact, the registrant only believes that its reasonable judgment will not be accepted by the staff.

Appeals Process

Finally, Mr. Hardiman explained the appeals process when a registrant does not agree with the staff's position. The dialogue should start with the staff accountant and the review accountant identified in the comment letter. If the registrant disagrees with the staff's decision, the registrant may request a more senior accountant to review this position. The first level of appeals is to discuss the issue with the senior assistant chief accountant and then the Division's Office of the Chief Accountant. There is also the opportunity to have the decision reviewed by the Office of the Chief Accountant of the Commission. Mr. Hardiman indicated that these various levels of review are in place to ensure there are appropriate checks and balances within the decision-making process and to balance the SEC's goals of protecting investors and facilitating capital formation.

Speech by Stephanie L. Hunsaker, *Associate Chief Accountant*, Division of Corporation Finance of the Securities and Exchange Commission

Topics Covered	Affects
• Consents and experts	SEC registrants

Ms. Hunsaker discussed circumstances in which a registrant is required to name and obtain consents from experts. She noted that during the past year, the SEC staff has seen an increase in the number of companies that have chosen to refer to an independent valuation firm or other expert in both registration statements under the Securities Act of 1933 and periodic reports under the Securities Exchange Act of 1934. She also indicated that she believed these references would most likely increase with the expanded use of fair value in the future. Some common examples of references to the use of an independent valuation firm or other expert were noted by Ms. Hunsaker:

- Reference to a valuation firm about the valuation of a registrant's common and preferred stock in an IPO.
- Reference to a valuation firm about the determination of a goodwill impairment.
- Reference to a valuation firm about the determination of an asbestos liability.
- Reference to petroleum engineers about the evaluation of oil and gas reserves.

Ms. Hunsaker stated that there is no requirement to refer to an independent valuation firm or other expert in filings made under the 1933 and 1934 Acts. If a registrant does not refer to the expert, the registrant is not required to name the expert or provide the expert's consent.

Periodic Reports Under the 1934 Act

For registrants that choose to refer to an independent valuation firm or other expert in periodic reports under the 1934 Act, such as Form 10-K or 10-Q, no consent is required. However, the SEC staff expects the referenced expert to be named in the filing. Ms. Hunsaker explained that by referring to the expert, management appears to transfer at least some responsibility to a third party, and investors have the right to know upon whom management has relied. Further, if the registrant incorporates a periodic report by reference in a 1933 Act filing, the requirements below apply.

Registration Statements Under the 1933 Act

A consent is required when a registrant refers to experts in 1933 Act filings. Ms. Hunsaker explained the requirement to include a consent in a 1933 Act filing under Rule 436(a) of Regulation C as follows:

> If any portion of the report or opinion of an expert or counsel is quoted or summarized as such in the registration statement or in a prospectus, the written consent of the expert or counsel shall be filed as an exhibit to the registration statement and shall expressly state that the expert or counsel consents to such quotation or summarization.

Ms. Hunsaker noted that the phrase "quoted or summarized" in Rule 436 of Regulation C is broadly interpreted by the SEC staff. **She also indicated that *any* reference to the expert, whether as the sole basis for a conclusion or as one of many factors considered by management in its evaluation, would require a consent.**

Ms. Hunsaker also clarified that even if a consent is required in a 1933 Act filing, the expert does not need to be named in the "Experts" section because the SEC forms do not require that disclosure.

Disclosure in the Consent

Ms. Hunsaker indicated that the valuation firm or other expert "may state that it does not admit to being an expert but it may not deny that it is an expert." In addition, the expert may not attempt to limit its liability under Sections 7 and 11 of the 1933 Act or "include language which attempts to state a legal conclusion as to which party is responsible for which item of disclosure." For example, an expert may not include disclosure in a consent stating that the responsibility of the valuation rests solely with the registrant.

Speech by Steven C. Jacobs, *Associate Chief Accountant*, Division of Corporation Finance of the Securities and Exchange Commission

Topics Covered	Affects
• Management's discussion and analysis of results of operations on a pro forma basis	SEC registrants

Item 303 of Regulation S-K requires a registrant to discuss its results of operations for the three years and interim periods covered by the financial statements that are included in a filing under the Securities Act of 1933 or the Securities Act of 1934. However, Mr. Jacobs acknowledged that there may be situations in which additional supplemental MD&A provide valuable and sometimes more relevant analysis to fully address trends and changes in registrants' results of operations. He indicated that supplemental MD&A disclosures based on pro forma financial information may be meaningful in the following circumstances:

- When a registrant acquires a large business.
- When a change in a registrant's basis because of push-down accounting results in the presentation of predecessor and successor results.
- When a newly formed entity acquires an operating company in a leveraged buyout transaction.

Editor's Note: The supplemental MD&A disclosures based on pro forma financial information are **not** required.

Further, in a separate question-and-answer session, Craig Olinger, deputy chief accountant, SEC Division of Corporation Finance, reiterated that this supplemental MD&A presentation is in addition to, and not in lieu of, the historical MD&A discussion. He also responded to several questions about pro forma MD&A presentation. The questions sought clarification of Mr. Jacobs's use of the term "large business combination" and of whether the staff believes that "large" is the same as "significant" as defined in Regulation S-X, or whether it is the same as a material business combination as used in Statement 141. Mr. Olinger explained that "large" in this context was not linked to "20 percent significance under Rule 3-05 or the filing of the 8-K" and is really a judgment about whether one is meeting the MD&A requirements in Item 303 of Regulation S-K.

Mr. Olinger stated that the intent of the remarks was to convey circumstances in which the historical presentation of financial statements may not fully lend themselves to MD&A presentation. He cited two examples, including "the classic example being the split period you get with a change in basis and another one being what we call a large business combination, and perhaps we should have called it **very** large (or something like that)."

Mr. Jacobs indicated that to determine whether supplemental pro forma MD&A may be provided, registrants should consider all the facts and circumstances surrounding the transaction, the nature of pro forma adjustments, and the overall relevance of the supplemental discussion. If it is determined that supplemental MD&A discussion is relevant and meaningful and enhances the discussion of the historical periods, the pro forma information should be prepared in accordance with Article 11 of Regulation S-X. **When predecessor and successor results are presented separately in the historical financial statements, combining these results without pro forma adjustments would not be appropriate.**

Editor's Note: Mr. Jacobs noted that the pro forma financial information should only include the transaction that has a significant effect on comparability. However, registrants should consider whether the application of Article 11 would require the inclusion of other significant consummated transactions that were previously reported in a Form 8-K.

Mr. Jacobs noted that the supplemental discussion of pro forma results should be for the fiscal year immediately preceding the transaction and for the current interim period. He also indicated that the staff would not object to the presentation of the comparative interim period, if appropriate, to facilitate the comparison. He further stated that it would be acceptable to carry the supplemental discussion to subsequent periodic reports in which it may still be relevant.

Editor's Note: The periods presented for the pro forma financial information should be determined on the basis of what would facilitate a meaningful comparison.

Mr. Jacobs indicated that a registrant should provide the following disclosures when it is determined that a supplemental pro forma MD&A is meaningful:

- How the pro forma presentation was derived.
- Why management believes that the presentation is meaningful.
- The potential risks associated with using the supplemental discussion.

With these disclosures, a registrant should typically include a complete set of pro forma financial statements, with all adjustments, to support the supplemental MD&A discussion.

Speech by Joel K. Levine, *Associate Chief Accountant*, Division of Corporation Finance of the Securities and Exchange Commission

Topics Covered	Affects
• Interactive data — XBRL	SEC registrants

Addressing one of the themes of the conference, Mr. Levine discussed various aspects of the XBRL project, including the development of a comprehensive U.S. GAAP taxonomy. The taxonomy is a collection of computer "tags" that can be applied to financial statement data and footnotes included in SEC filings to make the data interactive and more useful to investors. XBRL uses the tagging technology to provide investors with quicker access to the financial information they want, in a format they can most easily use. In addition to discussing the development of the taxonomy and its benefits, Mr. Levine spoke about (1) key characteristics of an ideal taxonomy, (2) the XBRL Preparers Guide, and (3) the SEC chairman's request to the staff.

Key Characteristics of an Ideal Taxonomy

Mr. Levine noted that an ideal taxonomy for XBRL possesses three key characteristics:

1. It includes a sufficient number of elements.
2. It has unique elements, with no two elements exactly alike.
3. It includes elements for all information an entity wants to tag.

These characteristics formed the basis of the taxonomy and resulted in an expansion of the previous taxonomy from 3,500 elements to nearly 12,000 elements. The intent was to include tags for financial statement line items and footnote information to minimize preparer customization (extensions). Extensions are tags entities place on information when there is no existing element within the current taxonomy. In Mr. Levine's view, there are now enough elements to minimize the need for extensions. While allowing extensions provides for flexibility by not limiting a company to only the elements in the current taxonomy, Mr. Levine noted that the increased use of extensions could reduce comparability among companies.

XBRL Preparers Guide

In connection with the development of the taxonomy, a plain English XBRL Preparers Guide is being published to help with the process of tagging financial statements. Mr. Levine noted that the development of the guide will promote consistent tagging and allow for increased comparability of tagged data across companies. The guide will cover a broad range of topics, from basic information on how the taxonomy is organized to information on how to create, review, and find elements within the taxonomy.

SEC Chairman's Request to the Staff

Mr. Levine also addressed a request from Chairman Cox for the SEC staff to make recommendations on ways to increase the benefits investors receive by tagging data. While the recommendations are not expected until the spring of 2008, Mr. Levine identified the following questions that will be subjects of the staff's focus:

- Should XBRL filings be voluntary or required for registrants?
- What is an appropriate implementation period?
- Should XBRL reports be filed or furnished?
- To what degree should footnote information be tagged?
- How will tagging extensions be handled?
- Should management certification and/or third-party assurance on the tagging of financial information be required?

Editor's Note: Information about XBRL is available on XBRL International's Web site and on the SEC's Web site. The Interactive Financial Report Viewer, which allows users to view, chart, and compare company financial information using U.S. GAAP taxonomies, is also available on the SEC's Web site.

On December 5, 2007, the SEC released the XBRL U.S. GAAP taxonomy for public comment. Mr. Levine encouraged all financial professionals to, among other things, "navigate" through the taxonomy and learn "how to find the elements you need." In particular, he indicated that XBRL US would appreciate feedback concerning "deficiencies that could present obstacles to widespread implementation."

In another speech, Mark Bolgiano of XBRL US noted that two registrants, Microsoft Corporation and EDGAR Online, Inc., have used the new taxonomy in their recent filings.

Editor's Note: See Deloitte & Touche LLP's December 10, 2007, *Heads Up* for additional information.

Speech by John W. White, *Director*, Division of Corporation Finance of the Securities and Exchange Commission

Topics Covered	Affects
• International matters • XBRL • Proxy matters • Other matters	Foreign private issuers SEC registrants

International Matters

Mr. White discussed three international initiatives addressed during 2007.

Deregistration

Mr. White first spoke about a rule that became effective June 4, 2007, that was adopted to allow foreign private issuers (FPIs) the option of deregistering from the U.S. reporting system if certain criteria are met. He stated that the new rule is based on the premise that if an FPI has the option to leave the U.S. reporting system, it is more likely to participate in the U.S. capital markets (i.e., making it easier to enter and exit the system).

Since the new rule became effective, almost 100 FPIs, representing approximately 9 percent of foreign issuers as of December 31, 2006, elected to deregister. However, there have been approximately 70 new listings in 2007.

International Financial Reporting Standards

While commenting on the SEC's recent adopting release and concept release on the use of IFRSs in SEC filings, Mr. White referenced a recent IFRSs review project. He noted that the goal of the project is to address concerns about the faithful and consistent application of IFRSs. During 2006, the Division of Corporation Finance reviewed over 100 filings of FPIs adopting IFRSs for the first time. The review project was one of the key items that allowed the Division staff to recommend that the SEC move forward with the adoption of the proposal to eliminate the U.S. GAAP reconciliation for FPIs.

Editor's Note: See the summary of remarks by Craig C. Olinger for further information about the SEC staff's IFRS review project.

Mutual Recognition

Mr. White stated that in June 2007, the Division held a roundtable to propose an initiative to allow select foreign stock exchanges and broker-dealers to operate in the United States without registering with the SEC. These exchanges and broker dealers are generally from countries that, according to the staff, have similar regulatory structures as the United States. The staff will continue to direct its focus on the qualifications and characteristics of the foreign issuers that trade under these exchanges or broker-dealers before making a final recommendation.

XBRL

In his discussion about recent XBRL developments, Mr. White noted that he expects recommendations from the SEC staff in the spring of 2008, with a possible final action on the use of XBRL by the end of the year. However, he indicated that the SEC would not mandate the use of XBRL until it was certain that the recently released taxonomy could be efficiently and effectively used. He also encouraged registrants to join the voluntary program to file with the SEC using XBRL. Mr. White also discussed the activities of the SEC Advisory Committee on Improvements to Financial Reporting.

Editor's Note: See the summary of remarks by Robert Pozen for further information on the SEC Advisory Committee on Improvements to Financial Reporting.

Proxy Matters

In July 2007, the electronic proxy initiative became effective. Mr. White stated that the initiative will allow for electronic availability of proxy materials for all investors. Under this format, registrants can use the following two methods when distributing proxy materials:

- *Notice Only* — Registrants can mail a notice to investors about the Internet availability of the proxy materials. No paper delivery of proxy materials would be required unless requested by an investor.
- *Traditional* — Registrants can deliver hard copies of the proxy materials to investors (as done in the past). If paper delivery of proxy materials is chosen, the registrant must also make the materials available electronically.

Registrants can also choose to mix the methods of proxy material delivery. For example, registrants could provide notice only for institutional investors and select traditional paper delivery for individual investors.

Other Matters

Item 4.02 of Form 8-K

Mr. White stated that the Division continues to work on codifying the requirement under Item 4.02 of Form 8-K to file a separate Form 8-K to inform investors when they can no longer rely on a registrant's financial statements. The Division is attempting to clarify its position of requiring appropriate disclosures in a Form 8-K to address the diversity in practice that has occurred when some companies make the disclosures in another filing, such as a Form 10-Q.

Oil and Gas Reserves

Mr. White indicated that the Division will issue a concept release to explore possible revisions to oil and gas reserve disclosure requirements.

Editor's Note: On December 11, 2007, the SEC voted to issue a concept release that will solicit comment on the required disclosure for oil and gas reserves.

Additional Topics

In addition to these topics, Mr White discussed (1) the SEC's smaller-public-company initiatives (see summary of remarks by speakers on smaller-public-company internal control initiatives), (2) SEC Chairman Cox's testimony on the deferral of section 404(b) for nonaccelerated filers (see summary of remarks by speakers on smaller-public-company internal control initiatives), and (3) the SEC staff's review of executive compensation disclosures (see summary of remarks by Barry Summer).

INTERNAL CONTROL OVER FINANCIAL REPORTING AND OTHER AUDITING MATTERS

Speeches by:

Martin F. Baumann, *Director of Office of Research and Analysis*, Public Company Accounting Oversight Board

George Diacont, *Director of Division of Registration and Inspections*, Public Company Accounting Oversight Board

Claudius Modesti, *Director of Division of Enforcement and Investigations*, Public Company Accounting Oversight Board

Topics Covered	Affects
• PCAOB inspections • PCAOB's Office of Research and Analysis • PCAOB disciplinary proceedings	SEC registrants and registered public accounting firms

PCAOB Inspections

Mr. Diacont discussed the limitations of the standard inspections report in providing detailed information to the public. For example, deficiencies in an accounting firm's system of quality control cannot be disclosed unless the accounting firm fails to address the deficiencies within a year. He noted, however, that the Board's bylaws and procedures allow for the issuance of other reports, commonly known as 4010 reports, such as the Report on the PCAOB's 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms, or "Small Firms Inspection Report." These reports allow greater flexibility in reporting on the Board's activities; can include details about inspection findings, quality-control deficiencies, and accounting and auditing issues, whether they relate to a firm or a group of firms that was subject to an inspection; and can provide information about identified trends. Mr. Diacont indicated that the Board expects to issue future 4010 reports on inspections of large firms that are based on inspection findings and the large firms' remediation processes and results.

Mr. Diacont then gave an overview of the Small Firms Inspection Report. He noted that the issues identified in the inspections of small firms were similar to those of large firms, and that the Board has noted improvements implemented by the small firms during the three-year inspection cycle in areas such as internal monitoring of audit processes and increased use of technology in monitoring quality. He also discussed a number of the deficiencies identified in the Small Firms Inspection Report, including deficiencies in audit procedures related to revenue recognition, related-party transactions, equity transactions, business combinations and impairment of assets, going-concern considerations, loans and accounts receivable (including allowance accounts), service organizations, use of other auditors, and use of the work of specialists.

PCAOB's Office of Research and Analysis

Mr. Baumann indicated that the Office of Research and Analysis provides support to all PCAOB groups. Its principal focus is to enhance the effectiveness and efficiency of the inspection process by helping improve the risk-based selection process used in identifying audits for inspection. Mr. Baumann noted that the ORA is primarily involved in the following four areas:

- *Supporting inspections* — The ORA assists inspections by identifying issuers with increased accounting risks or emerging issues and by identifying higher-risk audits.
- *Supporting standards* — The ORA identifies topics that require clarified or additional guidance. Mr. Baumann noted that the ORA was involved in the processes related to the recently issued Staff Audit Practice Alert No. 2, *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists*.
- *Audit risk working group* — Mr. Baumann noted that this group has been meeting for about a year and includes staff from the Center for Audit Quality and technical advisers from the eight annually inspected firms. The group holds bimonthly meetings; its agenda is based on emerging accounting and auditing risks and issues, such as fair value, the adoption of Statement 157 and Statement 159, and current credit market issues.

- *Small Business Forum* — The ORA works with the Small Business Forum on topics such as accounting for and auditing asset impairments, income taxes, stock compensation, business combinations, and off-balance-sheet arrangements.

PCAOB Disciplinary Proceedings

Mr. Modesti reiterated the PCAOB's broad authority to investigate potential auditor misconduct and to conduct disciplinary proceedings involving both registered public accounting firms and their personnel. He then discussed the following disciplinary proceedings:

- Deloitte & Touche LLP and a former audit partner of D&T failed to comply with certain PCAOB auditing standards, and D&T failed to adequately supervise the audit partner. The remedies for D&T include a censure, a civil monetary penalty of $1 million, and certain record-keeping undertakings. The former partner is barred from being an associated person of a registered public accounting firm.
- A KPMG staff person attempted to purchase stock in an audit client while she was a member of the audit engagement team. The staff person was sanctioned and is barred from being an associated person of a registered public accounting firm.
- An audit firm and audit partner failed to adhere to auditing standards regarding management's financial statement assertions of ownership rights to, and valuation and disclosure of, a material asset and certain "advances receivable"; an obligation to a third party; and a "payable to related parties." The firm's registration was revoked, and the partner is barred from being an associated person of a registered public accounting firm.
- An audit firm and audit partner failed to perform adequate audit procedures and failed to exercise due care and professional skepticism regarding financial statement assertions related to rights to bonds and related interest; the existence and valuation of a note; and the inclusion of certain nonmonetary exchanges in the statement of cash flows. The firm's registration was revoked, and the sole owner is barred from being an associated person of a registered public accounting firm.
- An audit partner failed to perform adequate audit procedures and failed to exercise due care and professional skepticism in the evaluation of evidential matter related to a reported gain on the sale of mining rights and its reported revenue with respect to products for which a right of return existed. The firm was censured, one partner is barred from being an associated person of a registered public accounting firm, and a second partner is suspended from being associated with a registered public accounting firm for one year.

Speeches by:

Richard D. Brounstein, *Member,* Financial Executives International, Representative on the 2007 COSO Monitoring Project

Cynthia M. Fornelli, *Executive Director*, Center for Audit Quality

Charles E. Landes, *Vice President*, Professional Standards and Services Group for the AICPA, AICPA Representative to COSO

Gerald J. Laporte, *Chief*, Office of Small Business Policy, Division of Corporation Finance of the Securities and Exchange Commission

D. Keith Wilson, *Associate Chief Auditor*, Public Company Accounting Oversight Board

Topics Covered	Affects
• Plan to delay requirement to comply with Section 404(b) of the Sarbanes-Oxley Act of 2002 • SEC smaller-public-company initiatives • PCAOB smaller-firm initiatives • COSO smaller-public-company initiatives	Audit firms Smaller public companies

Plan to Delay Requirement to Comply With Section 404(b) of the Sarbanes-Oxley Act of 2002

At a hearing held by the House Committee on Small Business, SEC Chairman Christopher Cox indicated that he intends to propose extending the deadline for nonaccelerated filers to comply with Section 404(b) of the Sarbanes-Oxley Act (i.e., the requirement to include the auditor's attestation report on the issuer's internal control over financial reporting in a company's annual report) to fiscal years ending on or after December 15, 2009. He is proposing the delay to enable the SEC staff to conduct a study of the costs and benefits of Section 404 compliance under the new PCAOB Auditing Standard 5 and SEC management guidance. A transcript of Chairman Cox's testimony can be found on the SEC's Web site.

SEC Smaller-Public-Company Initiatives

Mr. Laporte highlighted the SEC smaller-issuer initiatives resulting from recommendations of the SEC Advisory Committee on Smaller Companies. These initiatives included the following:

- Issuing guidance for management in performing its Section 404 assessment and a related "plain English" brochure, "Sarbanes-Oxley Section 404 — A Guide for Small Business." The interpretive guidance and "plain English" brochure can be viewed on the SEC's Web site.
- Adopting rule amendments for disclosure and reporting requirements for smaller companies under the Securities Act of 1933 and the Securities Exchange Act of 1934. The rule amendments allow companies with a public float of less than $75 million to qualify for the smaller company reporting requirements. The final rule, "Smaller Reporting Company Regulatory Relief and Simplification," is available on the SEC's Web site.
- Adopting amendments to the eligibility requirements of Securities Act Forms S-3 and F-3 to allow companies that do not meet the forms' current public float requirements to nevertheless register primary offerings of their securities, subject to certain restrictions. Additional details about the amendments are available on the SEC's Web site.
- Exempting private companies from a current requirement to register employee stock options if they have over 500 option holders.
- Revising Regulation D to create a new exemption from the registration provisions of the 1933 Act for offers and sales of securities to "large accredited investors." The proposed rule can be found on the SEC's Web site.

Editor's Note: See Deloitte & Touche LLP's, July 3, 2007, July 17, 2007, and November 16, 2007, *Heads Ups* for additional information.

PCAOB Smaller-Firm Initiatives

Mr. Wilson highlighted two smaller-firm initiatives by the PCAOB: (1) addressing internal control reporting and (2) hosting forums on auditing in the small business environment.

Addressing Internal Control Reporting

The PCAOB's internal control reporting initiatives are intended to assist auditors in applying the principles of Auditing Standard 5 in a smaller-public company environment. These initiatives are:

- Including scalability principles in Auditing Standard 5.
- Issuing for comment a document of preliminary staff views, *An Audit of Internal Control That Is Integrated With an Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies.*

Auditing Standard 5 and the Staff Guidance are available on the PCAOB's Web site. Although the preliminary staff views document is being exposed for public comment, Mr. Wilson indicated that the PCAOB is encouraging auditors to use the guidance now.

Hosting Forums on Auditing in the Small Business Environment

The small business forums hosted around the country by the PCAOB allow a dialogue to take place between the PCAOB and its staff and smaller firms, as well as between audit committee members and financial executives of smaller issuers. Twenty-six forums have been held over the past three years. Information about the forums, including upcoming dates, can be found on the PCAOB's Web site.

COSO Smaller-Public-Company Initiatives

Mr. Landes discussed the Committee of Sponsoring Organizations of the Treadway Commission's "Internal Control Over Financial Reporting — Guidance for Smaller Public Companies." This guidance is intended to:

- Assist smaller public companies in applying the "Internal Control — Integrated Framework."
- Illustrate ways to design and implement effective internal control in a cost-effective manner.

The guidance can be downloaded from the publications page on COSO's Web site.

Current Initiatives

COSO is currently drafting "Guidance on Monitoring Internal Control Systems." This document is intended to provide smaller public companies with insight on (1) how monitoring controls can be used in a cost-effective manner and (2) how to use evidence obtained from a company's monitoring controls to form management's assertion on effective internal control over financial reporting.

The document has been exposed and the comment period has ended. A second exposure draft is expected to be issued in early 2008 and will include additional examples. The document is expected to be finalized in the summer of 2008. The document is available on COSO's Web site.

Speech by Steven C. Jacobs, *Associate Chief Accountant*, Division of Corporation Finance of the Securities and Exchange Commission

Topics Covered	Affects
• Section 404 implementation issues	SEC registrants

Mr. Jacobs remarked that the staff is receiving an increasing number of requests from registrants for various forms of relief related to the internal control reporting requirements of Section 404 of the Sarbanes-Oxley Act of 2002. In many cases, the requesting companies have analogized themselves to newly public companies, which were granted a one-year transition period before being subject to the requirements of SEC Release No. 33-8760.

Throughout the discussion, Mr. Jacobs cautioned that companies seeking any such relief should not look to bright-line rules and encouraged companies to consult with the staff on their particular facts and circumstances.

The following examples were presented:

- *A private operating company recapitalizes into an existing nonoperating public shell company*. While the historical financial reporting may change to that of the operating company, the combined entity would not be considered a newly public company because the legal issuer has not changed. Therefore, the one-year transition period for newly public companies would not apply. However, the staff recognizes that the internal controls of the shell company may cease to exist before the end of the year in which the transaction occurred, and that sometimes the operating company may not be able to "effectively and efficiently" complete the assessment of ICFR in the year the transaction was consummated.
- *Two operating companies consummate a reverse merger*. Mr. Jacobs stated that these situations can be even more complex and noted the following two common questions related to reverse merger situations:
  - Can the legal acquiree (i.e., accounting acquirer) be excluded from the control assessment?
  - If the controls of the accounting acquirer are not required to be tested, can relief be obtained from forming an assessment altogether?

Mr. Jacobs noted that guidance in the September 24, 2007, Frequently Asked Questions Document, Question #3 ("FAQ #3"),[8] may allow an issuer to exclude the controls over a newly acquired business from management's assessment of ICFR as of the end of the fiscal year in which the acquisition took place. However, this guidance was not drafted with the reverse merger situation in mind. Therefore, the staff will continue to address the reporting requirements of a reverse merger on a facts-and-circumstances basis. He noted that the determination of whether to grant relief is based on:

- *Practicability* — Whether there is any piece of the assessment that is impracticable to complete.
- *Relevance* — Whether the conclusions related to the pieces of the assessment that are able to be performed would be meaningful and relevant to investors.

These factors would be assessed by considering the timing and terms of the transaction and how and when the changes will occur in the merged entity after the transaction. For example, Mr. Jacobs indicated that the earlier in the year the merger takes place, the more likely that integration of controls and processes can occur, allowing management to be able to make an assessment of the merged company's controls. The staff would also consider whether an assessment of only the legal acquirer's controls might be possible. This may be the case when the operations of the two entities have not been integrated as of the date of the assessment and the controls of the legal acquirer would be largely in place and capable of being assessed. He also indicated that the accounting treatment of the merger should generally not have any direct impact on the internal control environment and should not be the sole factor in determining management's ability to conduct an assessment of internal controls.

Mr. Jacobs noted that the relevance of an assessment limited to the legal acquirer would need to be considered. A registrant may conclude that the legal acquirer's share of consolidated revenue, expenses, income, and any other key operating measures were sufficiently insignificant to the consolidated total to render an assessment limited to the legal acquirer not meaningful. However, registrants must also consider the significance of the legal acquirer's assets and liabilities to the consolidated balance sheet. Mr. Jacobs stated that, especially after any step-up in basis, it may be difficult to conclude that an assessment limited to the legal acquirer is meaningless.

[8] *Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*: Frequently Asked Questions (revised September 24, 2007).

One example other than a reverse merger in which the application of FAQ #3 may not result in a meaningful assessment of internal controls effectiveness would be, according to Mr. Jacobs, a merger involving a special-purpose acquisition company (SPAC) acquiring an operating company. In the SPAC scenario, before the acquisition of the operating company, the SPAC is an issuer, typically capitalized though an IPO, that doesn't have any substantive operations. Accordingly, if the SPAC were to apply the guidance of FAQ #3 and exclude the operating company, there may be no meaningful controls to assess. This is because once the two entities are combined, the controls of the operating company typically are the only controls remaining to be subject to management's assessment. Mr. Jacobs stated that in this case and upon consideration of additional facts and circumstances, the staff might not object to entirely excluding management's report on ICFR in Form 10-K.

Editor's Note: In discussing the application of FAQ #3 to reverse merger situations, Mr. Jacobs took the opportunity to highlight the staff's views regarding its application in general. He specifically emphasized that the FAQ states that the staff "would typically expect management's report on internal control over financial reporting to include controls at all consolidated entities." While the staff has acknowledged that conducting an assessment might not always be possible because of the timing of the transaction or other reasons, Mr. Jacobs emphasized the significant judgment involved in this determination. He highlighted the situation in which companies using relief provided by FAQ #3 had completed mergers in their first quarter, even when those mergers were completed in the first month of the fiscal year, and he noted that if an assessment of the target was clearly possible considering timing and other circumstances, it would be difficult to understand how users are best served by excluding it.

Mr. Jacobs closed by emphasizing the importance of the transparency of disclosures in circumstances in which the company does not provide an assessment of internal controls or in which the assessment is limited in some other way. In particular, the staff recommends that the disclosure include a description of the transaction or situation, a discussion of why the assessment is not practicable or meaningful or why an entity has been excluded from the assessment, and if applicable, an explanation of what the company is doing to prepare for the next year. He also noted that in the case of a reverse merger in which there are significant changes in controls preventing management from performing an assessment of ICFR, there should be transparent disclosure summarizing the changes in controls.

Speech by Josh K. Jones, *Professional Accounting Fellow*, Office of the Chief Accountant of the Securities and Exchange Commission

Topics Covered	Affects
• Management's evaluation of internal control over financial reporting	SEC registrants and auditors of public companies

On June 20, 2007, the SEC issued interpretive guidance regarding management's report on internal control over financial reporting. The objective of this guidance is to help management improve the effectiveness and efficiency of its evaluation of ICFR. Mr. Jones provided insights into four specific aspects of the guidance:

- *Evaluation of design of ICFR* — The guidance provides that after identifying financial reporting risks, management needs to determine whether controls are in place to address these risks and, if so, whether the controls are designed to effectively prevent or detect misstatements that could result in material misstatements in the financial statements.

  Mr. Jones emphasized the importance and impact of timely design evaluation, noting that further evaluation of ineffectively designed controls is unnecessary. Therefore, early identification of a design deficiency should affect the number of controls subject to management's evaluation procedures and should also directly relate to the effort required on the part of management in performing its 404 assessment. He added that early identification of design deficiencies is fundamental to the quality of the assessment since management would receive information about control weaknesses before they result in a material misstatement in the financial statements.

- *Focus on areas of higher risk* — Mr. Jones noted that the guidance directs management to gather more evidence in higher-risk areas. This is intended to encourage management to focus on those areas that are subject to significant judgment or complex accounting requirements and that are common sources of restatements. He explained that "focusing management in this matter should help foster the earlier identification and remediation of deficiencies in internal control, and ultimately, provide more timely and reliable information for investors."

- *Evaluation of deficiencies* — Mr. Jones explained that an important component of effective internal control is timely identification of control breakdowns (e.g., before they result in errors in the financial statements). He pointed out that "it does not take an error in the financial statements to have a material weakness." Rather, management is expected to use all available facts and circumstances when evaluating a deficiency or combination of deficiencies to determine whether a material weakness exists. Mr. Jones stressed that management should "consider the root causes of each material weakness and whether its internal control system is designed to identify material weaknesses prior to the identification of an adjustment in the financial statements." He also stated that the staff may request information about management's evaluation of deficiencies to gain an understanding of how a company evaluated deficiencies that were determined not to be material weaknesses.

- *Disclosures of material weaknesses* — Mr. Jones noted that disclosures of material weaknesses have been criticized for not providing sufficient information to investors. The interpretive guidance contains a number of items management needs to consider including in its disclosures. In particular, the guidance explains that descriptions of material weaknesses should allow investors to distinguish between those weaknesses that have a pervasive impact and those that do not. He noted that descriptions of material weaknesses are often isolated to a specific area where the issue was discovered, even when there are two or more material weaknesses that might be linked by an underlying and more pervasive material weakness, such as a deficiency in the company's risk assessment or monitoring programs. He cautioned that management should be considering whether such broader weaknesses exist that may be the underlying cause of the deficiency or deficiencies identified.

Speech by Vassilios Karapanos, *Associate Chief Accountant*, Office of the Chief Accountant of the Securities and Exchange Commission

Topics Covered	Affects
• Auditor independence	SEC registrants and auditors of public companies

Frequently Asked Questions

Mr. Karapanos remarked that the staff continues to monitor the application of independence standards and issued nine new frequently asked questions in 2007. These questions address topics related to many areas and were incorporated into the staff's existing FAQ document.

In addition, during the year, the staff published a brochure addressing audit committees and auditor independence related issues. The brochure, which does not contain new staff guidance, highlights certain existing Commission rules and pronouncements.

The FAQ document and the brochure are available on the SEC's Web site.

Initial Public Offerings

Mr. Karapanos reminded the audience of the following:

- The Commission's rules on auditor independence require that the auditor is independent in each period for which an audit report will be required in a filing.
- Auditors and their audit clients should be mindful of the SEC's independence rules to the extent they affect private companies that may some day aspire to be public companies.

Accounting Application Assistance

An auditor may provide advice to an audit client regarding an accounting issue or subject without impairing its independence. However, in providing such advice, the auditor must be careful not to end up in the position of "auditing its own work" or "acting as management."

The Commission addressed this issue from an internal control perspective in its May 2005 statement on implementation of Section 404 requirements, which encourages frequent and transparent dialogue between management, auditors, and audit committees.

Mr. Karapanos also noted that the staff also looks to ISB Interpretation 99-1, "Impact on Auditor Independence of Assisting Clients in the Implementation of FAS 133 (Derivatives)," as adopted by the interim PCAOB Independence Standards Board, for general guidance when considering auditor consultations with audit clients regarding the application of accounting standards and principles.

Network Firms

Mr. Karapanos discussed the definition of network firms and noted that, in addressing independence questions regarding what constitutes an associated entity of an accounting firm, the staff will consider, among other facts and circumstances, questions such as the following:

- Does the primary auditor refer to another "network" firm in its audit opinion?
- Do the firms have common ownership, profit-sharing, or cost-sharing agreements?
- Do the firms share management, have a common brand name, or use shared professional resources?
- Do the firms have common quality-control policies and procedures?

Consents

Mr. Karapanos noted that an auditor has to be independent during the audit and professional engagement period, and he responded to the following two questions with respect to consents:

- Does a predecessor auditor have to be independent to issue a consent for a previously issued opinion?

  Mr. Karapanos stated that the answer is no, but that if a restatement of previously issued financial statements is involved, and the auditor is required to update its opinion, the auditor has to be independent for the new audit and professional engagement period.

- May a predecessor auditor that is not currently registered with the PCAOB issue a consent for a previously issued opinion on a newly public company?

  Mr. Karapanos said yes, but that the predecessor auditor could not consent or issue an opinion for a restatement because that involves additional audit work.

Editor's Note: In a subsequent question-and-answer session, Zoe-Vonna Palmrose, deputy chief accountant in the Office of the Chief Accountant of the SEC, addressed several questions regarding auditor independence.

With respect to the convergence of independence standards, Ms. Palmrose stated that it is important to recognize that the ethics standards are being revised at both the international and domestic levels. The staff is monitoring these activities, trying to compare and contrast the SEC independence rules with existing standards and the proposals, and is in the understanding mode at this point.

Ms. Palmrose also commented that it is important to recognize that the U.S. Treasury's Advisory Committee on the Auditing Profession has independence rules as one of the items on its agenda. She also noted that a number of the topics that it is exploring do touch on independence rules, so it will be a natural part of its dialogue to understand the rules and look at the interplay of those with any public policy recommendations.

With respect to new rule-making in the independence area and clarification of the affiliation definition in the context of private equity investors and investment company complexes, Ms. Palmrose indicated that the Commission has announced no independence rule-making publicly, but suggested that the audience "stay tuned" on that subject.

Speech by Zoe-Vonna Palmrose, *Deputy Chief Accountant*, Office of the Chief Accountant of the Securities and Exchange Commission

Topics Covered	Affects
• Improving effectiveness of 404 implementation • Sustaining a vibrant auditing profession • SEC's oversight of the PCAOB • Answers to audience questions	SEC registrants and auditors of public companies

Ms. Palmrose highlighted the major initiatives the Professional Practice Group in the Office of the Chief Accountant has focused on.

Improving Effectiveness of 404 Implementation

Ms. Palmrose explained that the Professional Practice Group focused much of its attention this past year on the new "Interpretive Guidance for Management" in conducting its required evaluation of internal control over financial reporting. She stated that improving the effectiveness of managements' and auditors' efforts with respect to Section 404 of the Sarbanes-Oxley Act of 2002 was the overarching objective both as the management guidance was developed and as the Professional Practice Group worked with the PCAOB on developing Auditing Standard 5. To help companies understand issues surrounding the implementation of Section 404 and to help small businesses understand the Interpretive Guidance for Management, the Commission published a "plain English" brochure.

Editor's Note: For additional comments on management's evaluation of ICFR, see the summary of remarks by Mr. Josh Jones.

Sustaining a Vibrant Auditing Profession

Ms. Palmrose also explained that the work of the Treasury Department's Advisory Committee on the Auditing Profession (the Advisory Committee) is of great interest, since this committee has been chartered to develop recommendations on how to sustain a "vibrant auditing profession." Co-chairs of the Advisory Committee are Arthur Levitt (former SEC chairman) and Don Nicolaisen (former SEC chief accountant). The committee is diverse, including investors, auditors, executives from large and small public companies, lawyers, educators, regulators, and companies that provide insurance for auditors. Ms. Palmrose explained that the OCA participates as an official observer to this committee. It is expected that the Advisory Committee will produce findings and recommendations by the early summer of 2008.

Editor's Note: A description of the Committee's objective and scope is included in its charter, which is available on the Treasury Department's Web site.

SEC's Oversight of the PCAOB

Ms. Palmrose described the role of the SEC in overseeing the activities of the PCAOB and identified various areas of oversight in which the OCA is involved, including:

- Appointment of Board members.
- Review and approval of annual PCAOB budget and five-year strategic plan.
- Conducting periodic, special, and other examinations of PCAOB programs and operations by working with the SEC's Office of Compliance, Inspections, and Examinations.
- Approval of PCAOB rules and professional standards.

Example

The Commission is inspecting the PCAOB's program for inspecting registered accounting firms. As part of this "inspection of inspections," the SEC staff is focusing on the PCAOB's compliance with the relevant provisions of the Sarbanes-Oxley Act as well as the PCAOB's own rules and procedures, and is considering the overall effectiveness of the inspection process in carrying out the PCAOB's mission.

Editor's Note: For additional information about the SEC's role in these, as well as other areas, see Brian Croteau's speech at the 2005 AICPA National Conference on SEC and PCAOB Developments, which is posted on the SEC's Web site.

Ms. Palmrose also noted that the OCA meets regularly with the PCAOB staff to discuss and provide input on the PCAOB's standard-setting activities and that a current priority for the Chief Accountant and OCA is how PCAOB standards compare with those of the International Auditing and Assurance Standards Board and the Auditing Standards Board. She remarked that the ASB has aligned its standard-setting agenda and activities with those of the IAASB. In addition, she indicated that the global convergence of auditing standards is a theme that has emerged from discussions at the PCAOB's Standing Advisory Group meetings. It also figures prominently in the recommendations of other groups, including the Government Accountability Office.

Ms. Palmrose concluded her formal comments by stating that she hoped her remarks would help instill a greater appreciation for the intricacies of the current regulatory structure.

Answers to Audience Questions

Ms. Palmrose discussed several topics in response to questions from the audience.

Restatements

Ms. Palmrose described a recent study from the PCAOB's Office of Research and Analysis that could imply that restatements do not carry much weight with investors because of their apparently insignificant impact on market responses. She emphasized that the results of the study represent preliminary findings and that these findings are likely to evolve as additional work is performed on this topic. Ms. Palmrose noted the discussion of the study at the October 2007 PCAOB Standing Advisory Group meeting; she believed that the results of the study might be affected by the failure of the study to consider various factors, such as:

- The type of restatement (e.g., earnings or revenue versus a one-time matter).
- The qualitative (e.g., fraud-related) or quantitative (e.g., materiality) nature of the restatement.
- The length of time covered by the restatement.

Nonaccelerated Issuers Failing to Perform, or Performing an Inadequate, Assessment of ICFR

Ms. Palmrose discussed situations in which nonaccelerated issuers fail to perform, or perform an inadequate, assessment of their ICFR in terms of Section 404(a) of the Act, as well as the implications for issuers and their auditors when the auditors are not required to audit the issuer's ICFR in accordance with Section 404(b) of the Act. She explained that an issuer's failure to file an assessment as required under Section 404(a) of the Act, or filing an assessment report that is not substantiated by reasonable support, constitutes noncompliance with Commission rules.

Ms. Palmrose further identified the implications for auditors in situations in which they are not engaged to audit ICFR under Section 404(b) of the Act, but instead are performing an audit of the financial statements only. She stated that if the auditor becomes aware of deficiencies when considering internal control during a financial statement audit, the auditor should:

1. Communicate all deficiencies to management, and all significant deficiencies and material weaknesses to management and those charged with governance.
2. Obtain an understanding of how management assesses identified deficiencies, while acknowledging that the complete perspective of compensating controls or other aspects of internal control that management may have

considered when performing its assessment might be lacking.

3. If, after step 2, it is still believed that management's consideration is not adequate, discuss concerns with those charged with governance and evaluate the company's response, if any.
4. If, after step 3, management's response is still determined to be inappropriate, consider whether management's assessment report in its annual report contains a material misstatement of fact and follows the guidance in AU Section 550.06.

Ms. Palmrose also stated that if the auditor believes either that management did not conduct an assessment under Section 404(a) of the Act or that management's assessment report does not have sufficient basis, the auditor should follow the guidance in AU Section 550.06.

INTERNATIONAL FINANCIAL REPORTING

Speech by Julie A. Erhardt, *Deputy Chief Accountant*, Office of the Chief Accountant of the Securities and Exchange Commission

Topics Covered	Affects
• Feedback received on SEC concept release	U.S. registrants

Ms. Erhardt discussed the feedback received from commenters on the SEC's recently issued *Concept Release on Allowing U.S. Issuers to Prepare Financial Statements in Accordance With International Financial Reporting Standards*.

Her remarks addressed the following questions:

1. How receptive are the U.S. capital markets on the move to global accounting standards beyond the Commission's recent action to accept IFRS financial statements prepared by foreign private issuers without a U.S. GAAP reconciliation?
2. How ready are investors and U.S. issuers for the move to global accounting standards?
3. If the Commission moves to adopt global accounting standards, what strategy best balances the needs of investors and issuers with providing the right incentives for the accounting standard-setting bodies?

According to Ms. Erhardt, commenters were generally in favor of the overall premise of a move to a single set of global accounting standards by U.S. issuers.

The comments received have indicated that some investors and issuers may be more ready for the transition to IFRSs than others. In terms of readiness, there appear to be different "categories" of investors and issuers. Investor categories include (1) those who endeavor to understand global accounting principles and have some familiarity with IFRSs, (2) those who endeavor to understand global accounting principles and have no familiarity with IFRSs, and (3) those who don't endeavor to understand global accounting principles. Issuer categories are (1) those that prepare full IFRS financial statements, in addition to U.S. GAAP financial statements, (2) those that don't prepare IFRS financial statements, but believe that they may have incentives to prepare them, and (3) those that don't prepare IFRS financial statements and have no incentive to do so.

The varying degrees of investor and issuer readiness create a policy problem for the Commission in its work toward convergence of accounting standards. Should convergence proceed along one track or along multiple tracks? Ms. Erhardt noted that allowing, but not requiring, U.S. issuers to file their financial statements in accordance with IFRSs would result in a multitrack approach to convergence. Although the multitrack approach may seem appealing, she acknowledged that it increases complexity because of the need to monitor which companies are on what track.

Two general questions about how to move U.S. issuers toward IFRSs have been identified from the comments received: (1) whether U.S. issuers should be permitted to use IFRSs, and if so, whether it should be a temporary or permanent option and (2) whether the use of IFRSs should be mandatory. In addition, Ms. Erhardt noted that some commenters questioned the potential impact on the convergence efforts between the FASB and the IASB if U.S. issuers are given an option to use IFRSs.

Ms. Erhardt closed her remarks by noting that a fundamental question contained in the comments was whether a market-based approach, a regulatory-based approach, or some combination of the two should be used in achieving the ultimate goal of moving to a single set of global accounting standards.

Editor's Note: More information on the proposed concept release and related comment letters received by the Commission can be found on the SEC's Web site.

Speech by Josh K. Jones, *Professional Accounting Fellow*, Office of the Chief Accountant of the Securities and Exchange Commission

Topics Covered	Affects
• Management's evaluation of internal control over financial reporting for foreign private issuers	Foreign private issuers

Mr. Jones presented statistics about the results of the first year of reporting by foreign private issuers (FPIs) under Section 404 of the Sarbanes-Oxley Act of 2002. This past year was the first year in which large accelerated and accelerated FPIs were required to report on management's evaluation of internal controls over financial reporting. About 500 of the 4,200 total registrants that reported on management's evaluation of internal control over financial reporting were FPIs. Of those FPIs, 45 reported one or more material weaknesses. Mr. Jones noted that the percentage of FPIs reporting material weaknesses (about 9 percent) was broadly comparable to that of domestic registrants reporting in the same period. In addition, and similarly to domestic registrants, the percentage of FPIs reporting one or more material weaknesses was disproportionately larger among what Mr. Jones called the "smaller issuers" (defined as less than $500 million in revenues).

In the three years since the initial reporting by domestic registrants under Section 404, the percentage of registrants reporting one or more material weaknesses has significantly decreased. Mr. Jones suggested that the fact that the percentage of FPIs reporting a material weakness in their initial year of adoption was broadly comparable to the percentage of domestic registrants reporting a material weakness in their third year may be due to some of the lessons the FPIs learned from examining the early years of implementation of the domestic registrants.

Mr. Jones also noted certain common trends between the nature of the material weaknesses reported by domestic registrants and that reported by FPIs. In both cases, the types of material weaknesses reported typically have been associated with financial statement elements such as income taxes, revenue recognition, liabilities, and fixed-asset valuation. These areas tend to be more complex and require significantly more judgment. Mr. Jones did note, however, that FPIs tended to report more material weaknesses associated with (1) controls surrounding the preparation of financial statements and related disclosures and (2) lack of competent accounting personnel. These weaknesses tended not to be related to the primary financial statements but to the preparation of the U.S. GAAP reconciliation.

Mr. Jones cited a concern that the disclosures indicate that the control deficiencies have not been discovered through management's evaluation process but through the identification of audit adjustments. In similar fashion to a speech he gave earlier in the conference, Mr. Jones noted that PCAOB Auditing Standard 5 is designed to encourage management to focus on areas that are subject to significant judgment or complex accounting requirements. He suggested that this would assist with earlier identification and remediation of deficiencies in internal control, and ultimately would provide more timely and reliable information to investors.

Frequently Asked Questions on Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports

Mr. Jones highlighted certain issues that the SEC staff has encountered regarding FPIs. Guidance about these issues was added to the September 24, 2007, amendment to the SEC's *Frequently Asked Questions on Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, or the "FAQ." These issues are:

- Scoping (addressed by Question 12 of the FAQ).
- Evaluating deficiencies (addressed by Question 13 of the FAQ).
- Differences in accounting for certain entities between home-country GAAP and U.S. GAAP (addressed by Questions 14 and 15 of the FAQ).

The FAQ is available on the SEC's Web site.

Speech by Len Jui, *Associate Chief Accountant*, Office of the Chief Accountant of the Securities and Exchange Commission

Topics Covered	Affects
• International initiatives to encourage improvements in audit quality	SEC registrants, foreign private issuers, and auditors of public companies

Mr. Jui summarized the activities of the International Organization of Securities Commissions (IOSCO), including the activities of the Standing Committee No. 1 on Multinational Accounting and Disclosure ("SC 1") that is chaired by Julie Erhardt, SEC deputy chief accountant in the Office of the Chief Accountant, as they relate to initiatives to encourage improvements in audit quality.

IOSCO is committed to improving audit quality and encouraging high-quality audit standards, and has demonstrated this by participating in the following activities:

- *Examining feedback from IOSCO roundtable on audit quality* — IOSCO is reviewing the ideas and suggestions discussed at the roundtable held on June 1, 2007, and is considering potential follow-up actions.
- *Chairing the Monitoring Group* — The Monitoring Group is an organization of which IOSCO is a founding member and that keeps watch over the governance and standard-setting processes of the International Auditing and Assurance Standards Board (IAASB) and the Public Interest Oversight Board.
- *Participating in the Consultative Advisory Group* — Through the Consultative Advisory Group, IOSCO provides ongoing advice to the IAASB. In 2007, SC 1 held 10 meetings to review and discuss the proposed International Standards on Auditing (ISA) that had been redrafted as a result of the Clarity Project.

To encourage further improvement in international auditing standards, on November 9, 2007, IOSCO issued a public statement recognizing the importance of high-quality international auditing standards and noting that it would consider possible future endorsement of ISAs for cross-border purposes. Mr. Jui explained, however, that at this time "there is a need for caution" because it is not yet clear how the IAASB will respond to comments that have been made by IOSCO and others regarding further improvements needed in the ISAs.

> **Editor's Note:** A description of the standing committee's objectives and goals are available on IOSCO's Web site.
>
> The video clip and transcript of the roundtable are available on IOSCO's Web site. The objective of the Clarity Project is to improve the clarity of ISAs through establishing conventions to be used in drafting future ISAs and applying those conventions to all existing ISAs.
>
> The full text of the IOSCO's statement is available on IOSCO's Web site.

Mr. Jui further explained that IOSCO's review of proposed ISAs focuses on the following:

- Whether the standards are set with the public interest as a foremost consideration.
- Whether the standards are likely to contribute to high-quality audits.
- Whether the standards are comprehensive and sufficient in scope.
- Whether the standards adequately cover all relevant aspects of the area of audit being addressed.
- Whether the standards are clear and understandable.
- Whether the standards are written to be enforceable by regulators.

Mr. Jui concluded by stating that standards alone are not enough to ensure high quality in audits. Audit oversight bodies are emerging in many countries and are likely to play a key role in determining whether the quality of standards is high and application is consistent around the world. In addition, education, training, development, and recruiting will all contribute to the promotion of high-quality audits.

Speech by Katrina A. Kimpel, *Professional Accounting Fellow*, Office of the Chief Accountant of the Securities and Exchange Commission

Topics Covered	Affects
• Faithful and consistent application of IFRSs	Preparers, auditors, regulators, and standard setters

Ms. Kimpel discussed regulators' efforts to ensure faithful and consistent application of IFRSs. She stated that although the guidance in IFRSs is not as detailed as that in U.S. GAAP, IAS 1 and IAS 8 do provide a *general* framework for preparers to follow when no *specific* guidance is available under IFRSs.

Fair presentation under IAS 1 requires financial statement preparers to faithfully represent the financial statement effects of transactions, events, and circumstances in accordance with the IFRS framework. IAS 8 requires that in the absence of specific accounting or reporting guidance, financial statement preparers should use professional judgment to develop appropriate accounting by considering the following items (listed in descending order of importance):

- IASB standards and interpretations.
- IASB framework.
- Other standard-setting bodies with similar conceptual frameworks (e.g., U.S. GAAP).

Ms. Kimpel pointed out that when exercising professional judgment, financial statement preparers should ensure that the accounting (1) is relevant to financial statement users, (2) is in accordance with the economic substance of the transaction, and (3) is determined objectively. She said that she could appreciate why, when there is a lack of guidance, IFRSs are applied in different ways in measuring or reporting a transaction. According to Ms. Kimpel, in such cases, the SEC staff generally asks the following questions when evaluating a particular accounting treatment or financial statement presentation:

1. Is the presentation fair?
2. Does the presentation provide relevant information for financial statement users?

Ms. Kimpel discussed the SEC staff's process for evaluating the presentation of transactions under IFRSs. The staff first reviews the applicable authoritative IFRS literature and then any implementation guidance. If questions about the standard or implementation guidance arise, the SEC staff will consult with the IASB staff. Before communicating its views to the issuer, the SEC staff will consult with the issuer's home-country regulator on matters that are unique or unprecedented.

Ms. Kimpel suggested that if auditors, financial statement preparers, standard setters, and regulators share their knowledge of, and experience with, applying IFRSs, this would lead to more consistent application. She remarked that the SEC staff believes that users need adequate information to compare IFRS financial statements. Consistent IFRS guidance should be used to account for similar types of transactions. To the extent that IFRS guidance has alternative accounting treatments that are appropriate for these transactions, financial statement preparers should provide adequate and transparent disclosures. She acknowledged that the preparation of IFRS financial statements is a fairly new process and that preparers often have considered their historical home-country GAAP when preparing IFRS financial statements. She acknowledged that questions have been raised about the influence of U.S. GAAP on the staff's review of IFRS filings. However, she mentioned that the staff will "consult with other regulators [for] support [that] our view is faithful to IFRS, not U.S. GAAP."

Ms. Kimpel indicated that the staff historically has consulted with other regulators when considering the accounting of foreign private issuers under their home-country accounting standards. However, with the increased worldwide use of IFRSs, the Commission has developed formal protocols for interacting with the other regulators, particularly those in Europe, to identify and address inconsistencies and inaccuracies in the application of IFRSs.

Ms. Kimpel noted that the following platforms have been established to interact with other regulators around the world:

- The August 2006 workplan between the SEC and the Committee of European Securities was established to prevent conflicting conclusions in application and enforcement of IFRSs. The workplan focuses on the application, by internationally active companies, of IFRSs and U.S. GAAP in the United States and the European Union and is implemented through protocols with each regulator. For example, the SEC, the U.K. Financial Services Authority, and the U.K. Financial Reporting Council (FRC) met in April 2007 and signed a protocol that permits sharing of information about application of IFRSs in financial statements filed in the United States with the SEC and those filed in the United

Kingdom. The protocol also provides consultation between the SEC and FRC on issues related to documents previously filed with the SEC as well as those that have not yet been filed with the SEC.

- Regulators may state their view on a particular issue with the assistance of the International Organization of Securities Commission's Standing Committee No. 1 on Multinational Disclosure and Accounting. To promote consistency in applying IFRSs, this committee meets frequently to discuss IFRS-related matters, including challenges various regulators raise against application of IFRS. In addition to this committee, IOSCO created a database to track regulators' views on the application of IFRSs. IOSCO monitors the issues tracked on the database and communicates them to the IASB or IFRIC.
- The SEC also developed "bilateral dialogues" with other regulators to promote consistent application of IFRSs. The SEC has formed dialogues with regulators such as the Korea Supervisory Commission, the Financial Services Agency of Japan, and the China Securities Regulatory Commission.

In her conclusion, Ms. Kimpel stressed that if IFRSs are to become the single globally accepted set of accounting and financial reporting standards, preparers, auditors, regulators, and standard setters around the globe must work together to support faithful and consistent application.

Speech by James J. Leisenring, *Member*, International Accounting Standards Board

Topics Covered	Affects
• IFRSs and convergence projects with the FASB	Preparers, auditors, and users of IFRS financial statements

Mr. Leisenring discussed the convergence efforts of the IASB and FASB, providing insight into the developments, challenges, and differences that the two boards have encountered throughout the convergence process. He also gave a general update of the projects on the IASB's agenda, emphasizing the importance of the conceptual framework project.

Convergence

Mr. Leisenring pointed out that the IASB and FASB share the same objective of developing a single set of high-quality, globally accepted accounting standards. To achieve this objective, the boards have undertaken various convergence efforts. Mr. Leisenring noted that although convergence has become a hot topic, it is not really a new idea but one that recently has been more formalized and rigorously implemented than it was in the past. He highlighted several developments and challenges in pursuing convergence.

Improvement Versus Convergence

Mr. Leisenring noted that to achieve common standards, standard setters need to deal with an ongoing "balancing act" between improvement of standards and convergence. For example, in its Improvements Project, the IASB made amendments to certain standards to achieve consistency with existing FASB literature. However, Mr. Leisenring acknowledged that certain decisions made as part of the Improvements Project were considered divergent. Nevertheless, the IASB believed that these decisions resulted in improved financial reporting.

Until 2005, the worldwide use of IFRSs was limited and was not closely scrutinized by regulators. Mr. Leisenring suggested that as the use of IFRSs becomes more widespread and scrutiny by regulators increases, questions about the application of IFRSs will continue to arise. He noted that the IASB will continue to address weaknesses in its guidance through the "Annual Improvements" process. He believes that coordination among interpretive bodies is important and that the EITF and the IFRIC (the interpretive arms of the FASB and IASB, respectively) must coordinate their efforts to prevent divergent interpretations of common standards.

Political Developments

Mr. Leisenring discussed the SEC's recent decision to allow foreign private issuers who prepare their primary financial statements in accordance with IFRSs, as published by the IASB, to file their financial statements without a U.S. GAAP reconciliation. He noted that this was a politically important milestone for the IASB because it gave IFRSs more credibility as a high-quality set of standards. He pointed out that the SEC's recent decision also stressed the importance of IFRSs "as published by the IASB" rather than jurisdictional versions of IFRSs.

Cultural Differences

Mr. Leisenring also discussed some of the difficulties arising from cultural differences between international and U.S. standard setting. First, he noted the "principles-based" versus "rules-based" distinction often mentioned in discussions regarding IFRSs versus U.S. GAAP. Although the "principles-based" distinction is usually attributed to IFRSs, he did note that there is a desire for more detailed IFRS implementation guidance internationally. However, he remarked that many would prefer that such guidance be viewed as an illustration of the principles rather than as prescriptive application guidance.

Second, he pointed out the limited industry-specific guidance in IFRSs versus U.S. GAAP. The IFRS hierarchy contains two levels of guidance. The standards and interpretations are the first level. Then, if there is no specific guidance in the standards, the guidance in the conceptual framework is applied. Companies also may look to the guidance of other standard-setting bodies with a similar conceptual framework. Mr. Leisenring noted that there are some industry-specific standards in IFRSs for insurance and extractive industries. Because these are temporary or transitional standards, the accounting used under IFRSs is typically consistent with the previous home-country GAAP. However, he acknowledged that these standards generally do not fit within the IFRS conceptual framework. Rather, the issuance of these standards was a short-term fix to prevent substantive disruption in the accounting for these industries. However, both insurance and extractive activities are being revisited and are currently on the IASB's agenda.

Finally, Mr. Leisenring noted that the IASB has to address issues that are unique to jurisdictions other than the United States. For example, the recent Exposure Drafts related to state-controlled entities (amendments to IAS 24) and separate financial statements (amendments to IFRS 1 and IAS 27) were created to address governmental and regulatory structures specific to certain countries, which may affect a company's accounting.

IASB Project Update

Mr. Leisenring also gave an overview of the projects on the IASB agenda. He emphasized that many of the active projects are joint convergence projects with the FASB. He noted that the SEC was instrumental in moving along the convergence process by encouraging the IASB and FASB to develop a formal Memorandum of Understanding. The MOU:

- Focuses on major projects on the agenda.
- Does not address every reconciling item.
- Does not converge inadequate standards.

Finally, Mr. Leisenring believes that of all the projects on the IASB and FASB agendas, the conceptual framework project is the most important. He emphasized that a common conceptual framework must be agreed upon before standard-setting convergence can work. He pointed out that disagreements about approaches at the "standards level" can only be resolved if there is agreement about the definitions of the elements in financial statements.

Editor's Note: For a listing and status of the projects on the IASB's agenda, see the IASB's Web site.

Speech by Janet Luallen, *Associate Chief Accountant*, Office of the Chief Accountant of the Securities and Exchange Commission

Topics Covered	Affects
• Update on international regulatory initiatives of IOSCO	Foreign private issuers

Ms. Luallen spoke about the international regulatory initiatives of the International Organization of Securities Commissions (IOSCO). She summarized the following current financial reporting issues and projects being addressed by IOSCO.

IOSCO International Disclosure Principles for Periodic Disclosure by Listed Entities

IOSCO is developing non-financial-statement disclosure standards in periodic reporting, such as annual and quarterly reports. This builds on IOSCO's prior project on initial listings and offerings disclosures. With this project, IOSCO hopes to develop an international consensus on the minimum standards for disclosure in periodic reporting, particularly annual reports. A draft of the standards is expected to be completed in 2008.

Global Auditing Standards

IAASB Clarity Project

IOSCO is closely monitoring and commenting on the International Auditing and Assurance Standards Board's Clarity Project. The project is aimed at clarifying and improving the existing International Standards on Auditing. A summary of the project is available on the International Federation of Accountants' Web site.

IOSCO Roundtable on Audit Quality

IOSCO held a roundtable on audit quality on June 1, 2007. The video clip and transcript of the roundtable are available on IOSCO's Web site.

Editor's Note: See the summary of remarks by Len Jui on the IAASB Clarity Project and IOSCO Roundtable on Audit Quality.

IOSCO's Current Work Program

In March 2007, IOSCO's Technical Committee published a consultation paper on its current work program. The paper sought comments from interested parties, and responses have been posted on IOSCO's Web site. Comments are currently being analyzed by IOSCO to identify priorities and determine whether additional work should be done on certain issues.

IOSCO Task Force on Recent Market Events

IOSCO formed the Task Force on the subprime crisis to address recent market events in the global credit market. The Task Force will conduct a preliminary review of the issues raised by these events to identify any implications for securities regulators that could be addressed currently and in the future.

IOSCO Task Force on Private Equity

The IOSCO Task Force on Private Equity was created to conduct a preliminary review of private equity markets. It issued its Consultation Report on Private Equity on November 29, 2007. The report's two objectives were to (1) identify any issues arising from the activities of the private equity industry that may create risks that affect IOSCO's objectives and principals and (2) identify steps to be taken by IOSCO. The report can be found on IOSCO's Web site.

Speech by Craig C. Olinger, *Deputy Chief Accountant*, Division of Corporation Finance of the Securities and Exchange Commission

Topics Covered	Affects
• Profiles of foreign private issuers • Proposed rule on acceptance from foreign private issuers of financial statements prepared in accordance with IFRSs without reconciliation to U.S. GAAP • Review of IFRS filings • U.S. GAAP reconciliation • Reporting issues	Foreign private issuers

Profiles of Foreign Private Issuers

Mr. Olinger noted that the profiles of approximately 1,100 foreign private issuers have shifted because of the recently issued rules allowing foreign private issuer deregistration under the Securities Exchange Act of 1934. The characteristics of the current profiles are (1) fewer European companies and more Asian companies, (2) fewer larger companies and more smaller companies, and (3) fewer traditional business companies and more technology companies.

Mr. Olinger estimated that among the 1,100 foreign private issuers, about 400 companies use Canadian GAAP, about 300 companies use U.S. GAAP, about 200 companies use IFRSs, and the remaining companies use other GAAP.

Proposed Rule on Acceptance From Foreign Private Issuers of Financial Statements Prepared in Accordance With IFRSs Without Reconciliation to U.S. GAAP

On July 2, 2007, the Commission issued a proposing release on the elimination of the U.S. GAAP reconciliation for foreign private issuers using IFRSs. The Commission received approximately 135 comment letters during the comment period, which ended on September 13, 2007. The Commission voted to approve a final rule on November 15, 2007. Since the final rule has not been published, Mr. Olinger said that he could not comment on specific implementation aspects of the rule. However, he provided the following insights.

- *Applicability and effective date* — The rule applies to foreign private issuers with fiscal years ending on or after November 15, 2007, with an effective date 60 days after publication of the final rule in the Federal Register. Mr. Olinger indicated that during the adoption of the final rule, the Commission considered the circumstances in which foreign private issuers elect to file their annual reports on Form 20-F before the effective date.
- *Eligibility requirement* — The rule applies to a foreign private issuer that files its financial statements in full compliance with the English-language version of IFRSs, as published by the IASB. The issuer is required to state such compliance in a footnote to the financial statements, and the issuer's independent auditors must opine on whether the financial statements do, in fact, fully comply. Mr. Olinger noted that there is a temporary accommodation available to existing European Union IFRS registrants who currently use the carve-out to IAS 39. Such registrants may file their financial statements for 2007 and 2008 without reconciling them to U.S. GAAP, if certain conditions are met. These conditions are discussed in the final rule.
- *Accommodation for first-time adopters of IFRSs* — Mr. Olinger noted that the existing rule, which allows first-time adopters of IFRSs to file two years, rather than three years, of financial statements in their SEC filings, is scheduled to expire at the end of 2007. The proposing release suggested extending this accommodation to 2012. Mr. Olinger remarked that the Commission received many comments on this, with a number of commenters suggesting an indefinite extension of the accommodation. The final rule will most likely take these comments into consideration.
- *Interim financial statements* — Under the proposed rule, a foreign private issuer that is not required to reconcile its annual financial statements to U.S. GAAP need not reconcile its interim financial statements included in a registration statement to U.S. GAAP. Under the proposed rule, registrants would need to comply with SEC Regulation S-X, Article 10. Mr. Olinger noted that many commenters suggested that compliance with IAS 34 should govern the

preparation of interim financial reporting. The final rule will most likely take these comments into consideration.

- *Interim financial statements in transitional registration statements* — The proposing release recommended retaining the transitional provisions related to interim financial statement requirements in registration statements filed in the year a registrant first adopts IFRSs. Mr. Olinger indicated that the Commission did not receive many comments on this item.
- *Impacts on other Form 20-F disclosures* — Mr. Olinger explained that under the proposing release, if the financial statements do not have to be reconciled to U.S. GAAP, other Form 20-F disclosures, such as selected financial data or MD&A, would not need to include U.S.-GAAP-related information. However, certain non-financial-statement disclosures, such as off-balance-sheet and market risk disclosures, contain definitional references to U.S. GAAP. Mr. Olinger noted that the proposing release requested commentary on whether Form 20-F should be amended to refer to IFRS guidance on such disclosures. Registrants should refer to the final rule for guidance on this issue.
- *Statement 69 disclosures* — The proposing release recommended retaining the disclosures under Statement 69. Mr. Olinger noted that the Commission did not receive many comments on this item.
- *Application of Rules 3-05, 3-09, 3-10, and 3-16* — Mr. Olinger noted that the provisions of the proposed rule would apply equally to foreign and domestic issuers filing financial statements of a foreign business under Regulation S-X, Rule 3-05, 3-09, 3-10, or 3-16. The Commission did not receive many comments on this item.

  Mr. Olinger further noted that the requirement to measure significance under Regulation S-X, Rule 3-05, depends on the basis of accounting used by the registrant. If the registrant uses IFRSs to prepare its financial statements without reconciliation to U.S. GAAP, the registrant would use IFRS amounts to perform the significance test.

Editor's Note: Although Mr. Olinger only discussed the requirement for significance testing under Regulation S-X, Rule 3-05, under the proposing release, the requirement to test significance under Regulation S-X, Rules 3-09, 3-10, and 3-16, would be the same.

- *Article 11 pro forma financial information* — The proposed rule requires registrants to present pro forma financial information in accordance with SEC Regulation S-X, Article 11, in the same basis of accounting as the registrant. Accordingly, a foreign private issuer using IFRSs would not be required to reconcile its pro forma financial information to U.S. GAAP.
- *Check boxes on the cover page of Form 20-F* — Currently, the cover of Form 20-F has check boxes for Item 17 or Item 18 reconciliation. Mr. Olinger pointed out that the rule proposed to add additional check boxes on the cover page of Form 20-F in which the registrant would indicate whether the financial statements included in the filing were prepared using U.S. GAAP, IFRSs, or another basis of accounting.

Editor's Note: For more information on the proposing release, see Deloitte & Touche LLP's July 9, 2007, and November 16, 2007, *Heads Up*s.

Review of IFRS filings

Mr. Olinger gave an update on the SEC staff's review of IFRS filings, including frequent staff comments.

He pointed out that the Division of Corporation Finance follows the same review process for all issuers, whether foreign or domestic. In 2006, the SEC staff reviewed virtually all the 2005 Forms 20-F of first-time adopters of IFRSs. On July 2, 2007, the SEC published "Staff Comments on Annual Reports Containing Financial Statements Prepared for the First Time on the Basis of International Financial Reporting Standards," which contains observations and frequent comment areas noted by the staff during its reviews.

Editor's Note: The staff report is available on the SEC's Web site.

In 2007, the SEC staff reviewed virtually all the 2006 Forms 20-F of the same companies that were reviewed in the previous year. Though these reviews are still in progress, Mr. Olinger shared some of his observations on them. In general, registrants were responsive in addressing the staff's concerns noted in the comment letters, and made improvements in the disclosures included in the 2006 Form 20-F, as demonstrated by the fact that fewer comments were noted during the reviews of the Form 20-F IFRS filings for 2006 than for 2005.

Mr. Olinger discussed the following areas on which the SEC staff has commented frequently:

- *Business combinations* — Comments have focused on the determination of value and the amortization period of intangible assets acquired in a business combination.
- *Revenue recognition* — Comments have centered on revenue recognition for multiple-element arrangements.
- *Asset impairments* — Comments have focused on the factors that led to asset impairment or, in certain instances, whether the registrant should record an impairment given the discussion of events and factors in other parts of the Form 20-F.
- *Loan impairments* — In certain cases in which a jurisdictional version of IAS 39 was used, the basis of presentation footnote and the audit report did not refer to this version of IAS 39. In such cases, the accounting policy applied differed from what was stated in the accounting policy footnote.
- *Financial instruments* — More comments on derivative and hedge accounting were issued during the reviews of the 2006 Forms 20-F, primarily because of (1) greater sensitivity to this topic as the SEC staff became more familiar with IAS 39 and (2) the related differences between IFRSs and U.S. GAAP. In addition, registrants that have early adopted IFRS 7 received comments related to the completeness of the disclosures required under IFRS 7.
- *Liabilities* — Comments focused primarily on the assumptions used in determining provisional liabilities under IAS 37.
- *Employee contribution* — Comments were related to compliance with the disclosure requirements under IFRS 2.
- *Cash flow statement presentation* — Comments on cash flow statement presentation during the reviews of the 2006 Forms 20-F were similar to comments issued during reviews of the 2005 Forms 20-F and primarily focused on the categorization of cash flow items as operating, investing, or financing.
- *Estimates and assumptions* — The SEC staff has commented on the appropriateness of reconciling differences between IFRSs and U.S. GAAP in the areas where they are substantially converged.
- *Segment reporting* — The comments on segment reporting primarily related to the basis of segmentation.
- *General disclosure* — The SEC staff expects full compliance with the disclosure provisions of IFRSs. In particular, certain disclosures required by the SEC may be presented outside of the financial statements by domestic registrants, are required disclosures under IFRSs, and must be included as part of the audited financial statements (e.g., certain disclosures under IFRS 7).
- *MD&A disclosure* — The SEC staff believes that it is important to clearly and fully analyze the financial statements in MD&A disclosure. The staff will continue to emphasize such disclosure, especially as standards become more principles-based.

U.S. GAAP Reconciliation

Mr. Olinger explained that in addition to the technical requirements under Items 17 and 18 of Form 20-F, the SEC staff evaluates the completeness of the U.S. GAAP reconciliation by determining whether (1) the footnotes to the U.S. GAAP reconciliation contain information similar to U.S. GAAP, as required under Item 17(a) of Form 20-F, and (2) U.S. information can be reconstructed on the basis of the information contained in the U.S. GAAP reconciliation.

Reporting Issues

MD&A Disclosure

Mr. Olinger made remarks regarding the importance of MD&A disclosure, regardless of the accounting principles used to prepare the financial statements, and emphasized that the SEC staff continues to focus on this area.

Disclosure Controls and Procedures

Mr. Olinger noted that during its review of IFRS filings, the SEC staff noticed instances of noncompliance attributable to the registrant's failure to state whether its disclosure controls and procedures were effective.

Requests for Review of Incomplete Filings

The SEC staff has received requests, from both domestic filers and foreign private issuers, for review of incomplete registration statements that are missing financial statements or that include insufficient periods of financial statements, with the understanding that the filing will be updated subsequently. Mr. Olinger gave an example of a request relating to financial statements required under SEC Regulation S-X, Rule 3-05. In this example, the registrant intended to use the combination of preacquisition and postacquisition periods to satisfy the financial statements requirement under Rule 3-05. Since the postacquisition period is 12 months, ending on December 31, 2007, the registrant requested whether the SEC staff is willing to review the initial filing without the audited postacquisition period. Mr. Olinger noted that unless the circumstances are extraordinary, the SEC staff generally is not receptive toward requests to review incomplete filings.

Appendix A: Glossary of Standards

FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements*

FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*

FASB Statement No. 157, *Fair Value Measurements*

FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*

FASB Statement No. 141(R), *Business Combinations*

FASB Statement No. 141, *Business Combinations*

FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*

FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*

FASB Statement No. 123(R), *Share-Based Payment*

FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*

FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*

FASB Statement No. 109, *Accounting for Income Taxes*

FASB Statement No. 69, *Disclosures About Oil and Gas Producing Activities*

FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*

FASB Statement No. 13, *Accounting for Leases*

FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*

FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities*

FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*

Accounting Research Bulletin No. 51, *Consolidated Financial Statements*

Proposed FASB Staff Position (FSP) No. FAS 157-b, "Effective Date of FASB Statement No. 157"

Proposed FASB Staff Position (FSP) No. FAS 157-a, "Application of FASB Statement No. 157 to FASB Statement No. 13 and Its Related Interpretive Accounting Pronouncements That Address Leasing Transactions"

Proposed FASB Staff Position (FSP) No. APB 14-a, "Accounting for Convertible Debt Instruments That May Be Settled in Cash Upon Conversion (Including Partial Cash Settlement)"

Proposed Statement 133 Implementation Issue No. E23, "Hedging — General: Issues Involving the Application of the *Shortcut Method* Under Paragraph 68"

EITF Issue No. 07-6, "Accounting for the Sale of Real Estate Subject to the Requirements of FASB Statement No. 66, *Accounting for Sales of Real Estate*, When the Agreement Includes a Buy-Sell Clause"

EITF Issue No. 07-5, "Determining Whether an Instrument (or an Embedded Feature) Is Indexed to an Entity's Own Stock"

EITF Issue No. 07-4, "Application of the Two-Class Method Under FASB Statement No. 128, *Earnings per Share*, to Master Limited Partnerships"

EITF Issue No. 07-1, "Accounting for Collaborative Arrangements"

EITF Issue No. 02-16, "Accounting by a Customer (Including a Reseller) for Certain Consideration Received From a Vendor"

EITF Issue No. 01-9, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)"

EITF Issue No. 01-6, "The Meaning of 'Indexed to a Company's Own Stock'"

EITF Issue No. 00-21, "Revenue Arrangements With Multiple Deliverables"

EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock"

AICPA Statement of Position 07-1, *Clarification of the Scope of the Audit and Accounting Guide* Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*

AICPA Statement of Position 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*

AICPA Statement of Position 97-2, *Software Revenue Recognition*

AICPA Statement on Auditing Standards No. 101, (AU Section 328) *Auditing Fair Value Measurements and Disclosures*

AICPA Statement on Auditing Standards No. 8 (AU Section 550), *Other Information in Documents Containing Audited Financial Statements*

AICPA Technical Practice Aid (Working Draft), "Convertible Debt, Convertible Preferred Shares, Warrants, and Other Equity-Related Financial Instruments"

SEC Regulation S-X, Article 11, "Pro Forma Financial Information"

SEC Regulation S-X, Article 10, "Interim Financial Statements"

SEC Regulation S-X, Rule 5-03(b), "Income Statements"

SEC Regulation S-X, Rule 4-08, "General Notes to Financial Statements"

SEC Regulation S-X, Rule 3-16, "Financial Statements of Affiliates Whose Securities Collateralize an Issue Registered or Being Registered"

SEC Regulation S-X, Rule 3-10, "Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered"

SEC Regulation S-X, Rule 3-09, "Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons"

SEC Regulation S-X, Rule 3-05, "Financial Statements of Businesses Acquired or to Be Acquired"

SEC Regulation S-K, Item 303, "Management's Discussion and Analysis of Financial Condition and Results of Operations"

SEC Staff Accounting Bulletin No. 107, codified as SAB Topic 14, "Share-Based Payment"

SEC Staff Accounting Bulletin No. 104, codified as SAB Topic 13, "Revenue Recognition"

SEC Staff Accounting Bulletin No. 99, codified as SAB Topic 1.M, "Materiality"

SEC Form 8-K, Section 4 — "Matters Related to Accountants and Financial Statements"

Item 4.02, "Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review"

SEC Regulation C, Rule 436, "Consents Required in Special Cases"

PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements*

PCAOB Auditing Standard No. 2, *Audit Documentation*

PCAOB Staff Audit Practice Alert No. 2, *Matters Relating to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists*

PCAOB Rule 4012, *Inspections of Foreign Registered Public Accounting Firms*

PCAOB Rule 4010, *Board Public Reports*

ISB Interpretation 99-1, "Impact on Auditor Independence of Assisting Clients in the Implementation of FAS 133 (Derivatives)"

IFRS 7, *Financial Instruments: Disclosures*

IFRS 2, *Share-based Payment*

IFRS 1, *First-time Adoption of International Financial Reporting Standards*

IAS 39, *Financial Instruments: Recognition and Measurement*

IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*

IAS 34, *Interim Financial Reporting*

IAS 27, *Consolidated and Separate Financial Statements*

IAS 24, *Related Party Disclosures*

IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*

IAS 1, *Presentation of Financial Statements*

Appendix B: Topical Index

Click a topic to jump to a summary.

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