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# Heads Up

Audit and Enterprise Risk Services

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## In This Issue:



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# Holiday Traditions 2006

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

*by Deloitte & Touche LLP's Accounting Standards and Communications, Assurance Services, and SEC Services Groups*

### Introduction

Every holiday season, well over 2,000 CPAs attend the AICPA's National Conference on Current SEC and PCAOB Developments. Over three days, roughly 65 standard setters, regulators, and top professionals make formal presentations, participate in panels, and answer hundreds of questions. Their goal? To make sure that financial statement preparers and auditors are armed, in advance of the financial reporting season, with the latest developments in accounting, auditing, and SEC rules and regulations.

This issue of *Heads Up* extracts key insights from nearly 26 hours of material. We haven't included information widely available elsewhere — for example, details on new or proposed accounting guidance can be found on the FASB's Web site at www.fasb.org. Instead, this *Heads Up* focuses on the unique viewpoints these experts shared on topics ranging from implementation of Interpretation 48[1] to changes the PCAOB has proposed on Auditing Standard 2.[2]

Here's how 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) to identify the major speakers and the topics they covered. Then, click a speaker's name to jump to a speech summary.

### Conference Themes

Professional judgment is indispensable. Speaker after speaker returned to this theme as it concerns financial statement preparation, tests of internal controls over financial reporting, and audits of financial statements. Also strongly echoed was last year's call for objectives-oriented, principles-based standards; today's rules are too complex and produce financial statements that are insufficiently transparent to users.

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

2 On December 19, 2006, the PCAOB issued for public comment a proposed new standard on auditing internal control over financial reporting that would replace Auditing Standard 2. The PCAOB also issued other related proposals.

Congressman Michael G. Oxley, one of the keynote speakers, discussed the contributions of the Sarbanes-Oxley Act of 2002 (the Act) — another message repeated throughout the conference. Congressman Oxley attributed much of the rise in investor confidence to the Act and pointed to a New York Stock Exchange survey indicating that four out of five CEOs see benefits from compliance. Interestingly, a number of speakers noted the Act's apparent success (and the foresight of its coauthors) in curtailing stock option backdating. So far, most identified backdating cases predate August 29, 2002, the effective date of new SEC rules (mandated by the Act) that require insiders to report stock transactions in as little as 48 hours.

Many speakers also emphasized eXtensible Business Reporting Language's (XBRL) potential. Randy Fletchall, vice chairman of the AICPA, characterized XBRL as making "virtually every participant in the financial reporting chain more productive." In 2007, XBRL will likely gain substantial traction, benefiting from an SEC investment of more than $50 million in EDGAR- and XBRL-related contracts to rebuild the public disclosure system.

Finally, international convergence and harmonization continue to be key in constructing a transparent, understandable financial system that can accommodate global capital markets.

## 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** |
| Randy G. Fletchall, *Vice Chair*, American Institute of Certified Public Accountants | • Transparency and complexity<br>• Principles-based standards<br>• International harmonization<br>• Enhanced Business Reporting Consortium and XBRL | All preparers, auditors, regulators, and users of financial statements |
| Robert H. Herz, *Chairman*, Financial Accounting Standards Board | • Complexity, transparency, and the Conceptual Framework | All preparers, auditors, and users of financial statements |
| Conrad Hewitt, *Chief Accountant*, Securities and Exchange Commission | • Major SEC initiatives | All preparers, auditors, and users of public company financial statements |
| Mark Olson, *Chairman*, Public Company Accounting Oversight Board<br>Thomas Ray, *Chief Auditor and Director of Professional Standards*, Public Company Accounting Oversight Board | • PCAOB current priorities<br>• The PCAOB's supervisory model to overseeing auditors<br>• International outlook<br>• PCAOB standard-setting priorities, including revisions to PCAOB Auditing Standard 2<br>• Stock option issues<br>• Consideration of fraud in a financial statement audit | All SEC registrants and auditors of public companies |
| Michael G. Oxley, *Congressman*, United States House of Representatives | • Capital markets and global terrorism | All preparers, auditors, regulators, and users of financial statements |

| U.S. ACCOUNTING PRINCIPLES | | |
|---|---|---|
| **Speaker** | **Topics Covered** | **Affects** |
| John W. Albert, *Senior Associate Chief Accountant*, Office of the Chief Accountant of the Securities and Exchange Commission | • Interaction between the SEC's Office of the Chief Accountant and the Enforcement Division | All SEC registrants |
| | • SEC Rule 102(e) — suspension for improper professional conduct | Auditors of public companies and corporate accountants with decision-making responsibilities for financial reporting |
| Paul Beswick, *Practice Fellow*, Financial Accounting Standards Board<br>Brett Cohen, *Partner*, PricewaterhouseCoopers LLP<br>Jenifer Minke-Girard, *Senior Associate Chief Accountant*, Office of the Chief Accountant of the Securities and Exchange Commission | • Interpretation 48 | All SEC registrants and auditors of public companies |
| Loretta Cangialosi, *Vice President & Controller,* Pfizer Inc<br>Don Charles, *Americas Director Valuation & Business Modeling*, Ernst & Young LLP<br>Craig Emrick, *Vice President – Senior Accounting Analyst*, Moody's Investors Service<br>Linda McDonald, *Director*, Financial Accounting Standards Board<br>Cheryl Tjon-Hing, *Valuation Specialist*, Office of the Chief Accountant of the Securities and Exchange Commission | • Valuation techniques (Statement 157), including remarks made in a separate session regarding accounting for emission allowances | Entities with assets and liabilities measured at fair value; entities that carry emission allowances at fair value |
| Cathy J. Cole, *Associate Chief Accountant*, Office of the Chief Accountant of the Securities and Exchange Commission | • Two-class method of computing earnings per share | Entities with multiple classes of stock or other securities that may participate in dividends |
| Todd E. Hardiman, *Associate Chief Accountant*, Division of Corporation Finance of the Securities and Exchange Commission | • Materiality judgments | All preparers and auditors of financial statements |
| Stephanie L. Hunsaker, *Associate Chief Accountant*, Division of Corporate Finance of the Securities and Exchange Commission | • Impact of registration requirements on embedded conversion options, freestanding warrants, and share forwards | Entities that issue securities with equity conversion or settlement rights (e.g., convertible debt, warrants), whether freestanding or embedded |
| Chad Kokenge, *Partner*, PricewaterhouseCoopers LLP<br>Allison T. Spivey, *Associate Chief Accountant*, Office of the Chief Accountant of the Securities and Exchange Commission | • Status report on option backdating<br>• Statement 123(R) | Entities that grant employee share-based payment awards |

| U.S. ACCOUNTING PRINCIPLES (cont.) | | |
|---|---|---|
| **Speaker** | **Topics Covered** | **Affects** |
| Timothy S. Kviz, *Professional Accounting Fellow*, Office of the Chief Accountant of the Securities and Exchange Commission | • Application of Statement 133 — issues involving hedge effectiveness | Entities that apply Statement 133 hedge accounting |
| Mark Mahar, *Associate Chief Accountant*, Office of the Chief Accountant of the Securities and Exchange Commission | • Materiality and SAB 108 | All SEC registrants and auditors of public companies |
| | • Application of Interpretation 46(R) and Issue 04-5 | Companies with general partner/limited partner arrangements |
| | • Professional judgment in accounting decisions and auditor independence | All preparers and auditors of financial statements |
| Joseph D. McGrath, *Professional Accounting Fellow*, Office of the Chief Accountant of the Securities and Exchange Commission | • Fair value | |
| | • Derivative inception gains | Derivative and commodity dealers |
| | • Arrangements with multiple accounting components | Companies that enter into arrangements with multiple accounting components |
| | • Accounting for inventory | Derivative and commodity dealers |
| | • Revenue recognition and transfers of financial assets | Companies that transfer rights to future cash flows |
| | • Hedge documentation | Companies that apply hedge accounting |
| Jeffrey D. Mechanick, *Project Manager*, Financial Accounting Standards Board | • Statement 158 overview and implementation questions | Sponsors of defined benefit pension and other postretirement plans |
| Leslie Overton, *Associate Chief Accountant*, Division of Corporation Finance of the Securities and Exchange Commission | • Form and content of financial statements in an IPO<br>• Push-down accounting | Entities engaged in an IPO involving the merger of entities under common control |
| Carol A. Stacey, *Chief Accountant*, Division of Corporation Finance of the Securities and Exchange Commission | • Analyzing statements of cash flows | Companies presenting a statement of cash flows |
| Scott A. Taub, *Deputy Chief Accountant*, Office of the Chief Accountant of the Securities and Exchange Commision | • Applying professional judgment in financial reporting | All preparers and auditors of financial statements |
| Joseph B. Ucuzoglu, *Professional Accounting Fellow*, Office of the Chief Accountant of the Securities and Exchange Commission | • Purchase price allocations<br>• Unfavorable revenue contracts<br>• Customer relationship intangible assets | Companies that acquire businesses |
| | • Option grants with administrative delays | Companies that issue stock options |
| | • Special classes of stock granted to employees | Companies that use special classes of stock to compensate employees |
| | • Postretirement benefit plan amendments | Companies with pension and other postretirement benefit plans |

| SEC MATTERS | | |
|---|---|---|
| **Speaker** | **Topics Covered** | **Affects** |
| Tom Church, *Partner*, Deloitte & Touche LLP<br>Jeff Naumann, *Enabling Technology Specialist*, Office of the Chief Accountant of the Securities and Exchange Commission<br>Campbell Pryde, *Managing Director*, Morgan Stanley<br>John Stantial, *Director of Financial Reporting*, United Technologies Corporation<br>Liv Watson, *Vice President of Global Strategies*, Edgar-Online<br>Mike Willis, *Partner*, PricewaterhouseCoopers LLP | • XBRL overview and in-depth panel discussion | All SEC registrants |
| Louise M. Dorsey, *Associate Chief Accountant*, Division of Corporation Finance of the Securities and Exchange Commission | • Item 4.02 Form 8-K issues<br>• Shell company reporting | All SEC registrants involved in a restatement<br>Shell company registrant that has merged with a private operating company |
| Craig C. Olinger, *Deputy Chief Accountant*, Division of Corporation Finance of the Securities and Exchange Commission | • Recent SEC staff comments | All SEC registrants |
| Walter G. Ricciardi, *Deputy Director*, Division of Enforcement of the Securities and Exchange Commission | • How to stay out of trouble with the Division of Enforcement | All SEC registrants and auditors of public companies |
| Carol A. Stacey, *Chief Accountant*, Division of Corporation Finance of the Securities and Exchange Commission<br>John W. White, *Director*, Division of Corporation Finance of the Securities and Exchange Commission | • Executive compensation disclosure<br>• Restatements resulting from errors in stock option accounting | All SEC registrants<br>Companies subject to restatements from errors in stock option accounting |
| Sondra L. Stokes, *Associate Chief Accountant*, Division of Corporation Finance of the Securities and Exchange Commission | • MD&A of financial condition and results of operations | All SEC registrants |

**INTERNAL CONTROL OVER FINANCIAL REPORTING AND OTHER AUDITING MATTERS**

| Speaker | Topics Covered | Affects |
|---|---|---|
| George Diacont, *Director of Division of Registration and Inspections*, Public Company Accounting Oversight Board<br>Phil Peters, *Deputy Director of International Inspections Division of Registration and Inspections*, Public Company Accounting Oversight Board<br>Phil Wedemeyer, *Director of Office of Research and Analysis*, Public Company Accounting Oversight Board | • PCAOB inspections<br>• PCAOB international inspections<br>• PCAOB's Office of Research and Analysis | All SEC registrants and registered public accounting firms<br>Registered public accounting firms |
| Michael Gaynor, *Professional Accounting Fellow*, Office of the Chief Accountant of the Securities and Exchange Commission | • Management's evaluation of internal control over financial reporting | All SEC registrants and auditors of public companies |
| Michael W. Husich, *Associate Chief Accountant*, Office of the Chief Accountant of the Securities and Exchange Commission | • Auditor independence | All 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 audit effectiveness | All SEC registrants and auditors of public companies |

**INTERNATIONAL FINANCIAL REPORTING**

| Speaker | Topics Covered | Affects |
|---|---|---|
| G. Michael Crooch, *Vice-Chairman*, Financial Accounting Standards Board<br>Julie A. Erhardt, *Deputy Chief Accountant*, Office of the Chief Accountant of the Securities and Exchange Commission<br>Janet L. Pegg, *Senior Managing Director,* Bear Stearns & Co. Inc. | • IASB Agenda<br>• Application of IFRS in practice<br>• IFRS from the investor's perspective | All preparers, auditors, and users of IFRS financial statements<br>Foreign private issuers who prepare financial statements under IFRS<br>All preparers, auditors, and users of IFRS financial statements. The remarks summarized in this section expressed views on broad issues facing the financial reporting community |

| INTERNATIONAL FINANCIAL REPORTING | | |
|---|---|---|
| **Speaker** | **Topics Covered** | **Affects** |
| Craig C. Olinger, *Deputy Chief Accountant*, Division of Corporation Finance of the Securities and Exchange Commission | • Internal controls over financial reporting under Section 404 of the Sarbanes-Oxley Act<br>• Exchange Act deregistration by foreign private issuers<br>• IFRS implementation<br>  • Review process<br>  • Frequent staff comments<br>• U.S. GAAP reconciliations<br>• Reporting issues<br>  • SAB 108<br>  • Parent–only schedules under Regulation S-X<br>  • Mandatory minimum dividends<br>  • Foreign GAAS | Foreign private issuers who prepare financial statements under IFRS and their auditors |
| Janet Luallen, *Associate Chief Accountant*, Office of the Chief Accountant of the Securities and Exchange Commission | • IOSCO IFRS Database Arrangement | |

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 *Heads Up* with the SEC staff or with any other organization we refer to.

**Editor's Note:** Members of the following Deloitte teams contributed to this issue of *Heads Up*: Accounting Standards and Communications, Assurance Services, and SEC Services. Each of us wishes a joyous and peace-filled holiday to our colleagues at Deloitte, our clients, and our other friends.

# Summaries of Speeches and Other Comments 2006 AICPA National Conference on Current SEC and PCAOB Developments

## KEYNOTE SPEAKERS

### Speech by Randy G. Fletchall, *Vice Chair*, American Institute of Certified Public Accountants

| Topics Covered | Affects |
|---|---|
| • Transparency and complexity<br>• Principles-based standards<br>• International harmonization<br>• Enhanced Business Reporting Consortium and XBRL | All preparers, auditors, regulators, and users of financial statements |

#### Transparency and Complexity

Mr. Fletchall remarked that to achieve greater transparency in financial reporting, the profession needs to address the complexity of accounting standards. He stated that mere simplification of accounting standards may not solve the problem — or even be appropriate — as business transactions are more complex than ever. Rather, he indicated that the profession should work to make information more understandable to investors and creditors.

#### Principles-Based Standards

Mr. Fletchall indicated that standards that are based on broad principles, rather than rigid rules, enjoy considerable and growing support within the accounting community and the financial markets as a means to increasing transparency and reducing complexity. However, he observed that "principles-based accounting is a tricky business" because it requires:

- Greater reliance on professional judgment.
- Acceptance and tolerance; different preparers and auditors will sometimes reach different conclusions in good faith.
- Transparent disclosure such that users are able to understand the accounting decisions made and the potential effects of other alternatives.

He emphasized that care should be taken not to conceptualize "principles-based" standards at too high a level, thereby losing comparability.

#### International Harmonization

Mr. Fletchall noted that harmonization (or convergence) of U.S. generally accepted accounting principles (GAAP) with International Financial Reporting Standards (IFRS) (typically a more principles-based approach) helps to reduce complexity and increase transparency. He added that the world has become a global marketplace, with national boundaries becoming increasingly irrelevant in accessing capital and creating wealth.

## Enhanced Business Reporting Consortium (EBRC) and XBRL

Continuing with the theme of increasing transparency and reducing complexity, Mr. Fletchall informed participants that the EBRC is developing a best-practices, high-level, structured framework for the disclosure of key value drivers, financial and non-financial performance measures, and qualitative information on strategy, plans, opportunities, and risks — information that is not covered by the financial statements and notes. The EBRC is conducting research to serve as the basis for recommendations for simplification of existing reporting requirements. Mr. Fletchall further elaborated that XBRL will play an important role in increasing transparency and overall usability of financial statements.

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

| Topics Covered | Affects |
|---|---|
| • Complexity, transparency, and the Conceptual Framework | All preparers, auditors, and users of financial statements |

Echoing his sentiments from last year's conference, Mr. Herz discussed the "dual edge" problem in financial reporting — complexity, coupled with lack of transparency. Mr. Herz indicated that the consequences of complexity are far reaching and include continuing constituent demand for rules-based standards, a discomfort among preparers and auditors in applying professional judgment, and the continuing need to restate financial statements. While reiterating that all parties involved must take action, Mr. Herz detailed the FASB's approach to addressing complexity and transparency: (1) readdressing complex and outdated standards (with a focus on International Accounting Standards Board (IASB) convergence), (2) improving the understandability of guidance, and (3) developing the joint Conceptual Framework.

**Editor's Note:** Larry Smith, FASB director of technical application and implementation activities, underscored the FASB's understandability initiative. Later in the conference, Mr. Smith noted that the proposed standard on the fair value option is being revised to improve its understandability before final release.

Mr. Herz's remaining remarks focused on the joint Conceptual Framework project and its role in reducing complexity. He stated that once completed, it will provide numerous payoffs, including a common ground for reasoning, more consistent conclusions on similar issues, principles-based standards, and better financial reporting. Mr. Herz noted that the project is being conducted in phases, with a focus on "cross-cutting issues" and that one such issue is the potential trade-off between relevance and reliability of financial information, exemplified through the debate about reporting items at fair value versus historical cost. With an eye toward the advantages of fair value in appropriate contexts, Mr. Herz quipped that investors are "not that interested in highly reliable, irrelevant stuff." Although the project is in its early stages, Mr. Herz made it clear that the FASB and IASB are committed to its completion.

## Speech by Conrad Hewitt, *Chief Accountant*, Securities and Exchange Commission

| Topics Covered | Affects |
|---|---|
| • Major SEC initiatives | All preparers, auditors, and users of public company financial statements |

Mr. Hewitt provided context on areas covered in later staff speeches. He outlined several of the Commission's major initiatives, including:

- Management Guidance Program.[3]
- Revisions to Public Company Accounting Oversight Board (PCAOB) Auditing Standard 2,[4] *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements.*
- XBRL.
- International Affairs.

Mr. Hewitt indicated that the goal of the Management Guidance Program is to provide principles-based guidance for registrants' management as it designs, evaluates, and assesses internal controls over financial reporting. He remarked that the guidance, designed for companies of all sizes, takes a risk-based approach, emphasizing "tone at the top" and entity-level controls.

Mr. Hewitt noted that the SEC is also working with the PCAOB to revise PCAOB Auditing Standard 2. He indicated that, consistent with the Management Guidance Program, the revised standard will ask auditors to start by considering "tone at the top" and focus on material risk areas. He also remarked that the revised standard will emphasize benefits that can be obtained from increased use of the work of others and better integrating the audit of internal controls over financial reporting with the financial statement audit.

Mr. Hewitt reiterated the SEC's commitment to XBRL (eXtensible Business Reporting Language), as evidenced by multi-million dollar investments by the SEC and Financial Accounting Foundation, but indicated that the Commission has not yet decided whether it will require XBRL in future registrant filings. Mr. Hewitt also highlighted the SEC's IFRS Roadmap, which lays out a plan to potentially eliminate the requirement for registrants that prepare their financial statements in accordance with IFRS to reconcile to U.S. GAAP.

3 On July 11, 2006, the SEC issued for public comment *Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting*.

4 On December 19, 2006, the PCAOB issued for public comment a proposed new standard on auditing internal control over financial reporting that would replace Auditing Standard 2. The PCAOB also issued other related proposals.

## Speeches by:

## Mark Olson, *Chairman*, Public Company Accounting Oversight Board

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

| Topics Covered | Affects |
|---|---|
| • PCAOB current priorities<br>• The PCAOB's supervisory model to overseeing auditors<br>• International outlook<br>• PCAOB standard-setting priorities, including revisions to PCAOB Auditing Standard 2<br>• Stock option issues<br>• Consideration of fraud in a financial statement audit | All SEC registrants and auditors of public companies |

### PCAOB Current Priorities

Mr. Olson initially focused on the current priorities of the PCAOB, which include (1) continuing to move the PCAOB from a start-up phase into a steady state, (2) continuing to assess its oversight program as the PCAOB learns from the inspections process, and (3) focusing on standard setting — including establishing standard-setting priorities and receiving input — both before and after the effective date of a standard or rule. He acknowledged that the PCAOB is at a critical stage in its rule-making initiative for revising the auditing standard on internal control over financial reporting (ICFR).

**Editor's Note:** Additional comments regarding the PCAOB's standard-setting activities and priorities were discussed by Mr. Ray, and are summarized below.

### The PCAOB's Supervisory Model to Overseeing Auditors

In Mr. Olson's view, the PCAOB's mandate to oversee the auditors of public companies continues to be best accomplished through robust supervision that is premised on good communication between accounting firms and external stakeholders. Mr. Olson outlined a few areas on which inspectors focus, including the following:

- Objectivity of audit teams and whether auditors are evaluating both corroborative and contradictory evidence.
- Strains on individual partner capacity that may contribute to issues with audit quality.
- Compensation practices and whether they provide incentives likely to promote audit quality and technical competence.
- How audit teams are complying with SAS 99 (e.g., whether auditors are appropriately modifying the nature, timing, and extent of audit procedures in response to fraud risks, and whether they are varying their audit procedures to bring an element of unpredictability to the audit process).
- The quality of the execution of the engagement quality (concurring partner) review process, whether the involvement of the concurring partner corresponds to the firm's assessment of audit risk, and whether the engagement quality review is providing an independent and objective assessment.

Mr. Olson concluded his remarks on the supervisory model by stating that the PCAOB's job is to improve the quality and reliability of public company audits so that investors are more confident in audited financial statements.

## International Outlook

With respect to international policy issues, Mr. Olson emphasized that regulatory coordination with non-U.S. oversight bodies is imperative. In his view, with more than 700 registered audit firms operating outside the United States, audit oversight bodies must work together to minimize the burdens of duplicative or contradictory regulation while ensuring that statutory obligations to the public and investors are met. Mr. Olson believes that healthy competition among various global markets should be embraced and that regulation, if balanced, attracts capital and builds confidence in markets.

## PCAOB Standard-Setting Priorities

### Standard-Setting Activities Related to PCAOB Auditing Standard 2

Both Mr. Olson and Mr. Ray discussed the PCAOB's current project to modify Auditing Standard 2.[5]

Mr. Olson stated that the PCAOB is committed to making the standard simpler to read, easier to understand, and more clearly scalable to companies of any size. It will also help auditors focus on the most important subject areas. Mr. Ray added that the new standard will, among other changes:

- Integrate PCAOB Staff Guidance, "Staff Questions and Answers — Auditing Internal Control Over Financial Reporting."
- Revise the definitions of "material weakness" and "significant deficiency."
- Address using the work of others and using prior-year testing.

Mr. Ray also indicated that the PCAOB, with the assistance of several public accounting firms, is developing guidance for auditors of smaller public companies, which will be piloted in 2007.

### Other Standard-Setting Activities

Mr. Olson and Mr. Ray also discussed other PCAOB standard-setting activities. Mr. Ray indicated that the PCAOB will continue, or initiate, projects on the following topics in 2007:

- Engagement quality review.
- Risk assessment.
- Related parties.
- Confirmations.
- Use of specialists.

**Editor's Note:** In response to a question from the audience, Mr. Ray estimated that the revised engagement quality review standard would be proposed before the end of 2007. In response to a separate question, Laura Phillips, deputy chief auditor of the PCAOB, estimated that revised risk assessment standards would also be proposed before the end of 2007.

## Stock Option Issues

### Backdating of Stock Options

Mr. Ray noted that on July 28, 2006, the PCAOB issued its first Staff Practice Alert, *Matters Related to Timing and Accounting for Option Grants*, in response to backdating issues that have been identified. Mr. Ray reiterated the importance of the auditor in:

- Maintaining professional skepticism throughout the audit.

5 On December 19, 2006, the PCAOB issued for public comment a proposed new standard on auditing internal control over financial reporting that would replace Auditing Standard 2. The PCAOB also issued other related proposals.

- Not accepting anything less than persuasive evidence.
- Using the brainstorming session required by SAS 99 to discuss risks related to the stock option practices of the company.

#### Fair Value of Stock Options

Mr. Ray referred to PCAOB Staff Guidance, "Staff Question and Answers — Auditing the Fair Value of Share Options Granted to Employees," which provides guidance on auditing the fair value of stock options under Statement 123(R).

### Consideration of Fraud in a Financial Statement Audit

Mr. Ray reviewed some of the key provisions of SAS 99, reiterating that the auditor should not be "mechanistic" about complying with its requirements but may need to vary the nature, timing, and extent of the audit procedures performed in response to the identified risks. He stated that documenting risk assessment considerations is important and indicated that the PCAOB's 2007 project to revise the risk assessment standards would include more integrated links between the fraud risk assessment and the overall risk assessment.

Mr. Ray then expressed support for the involvement of the engagement quality reviewer in the fraud brainstorming session conducted by the engagement team. He stated that he did not believe that this involvement would impair the objectivity of the engagement quality reviewer.

## Speech by Michael G. Oxley, *Congressman*, United States House of Representatives

| Topics Covered | Affects |
|---|---|
| • Capital markets and global terrorism | All preparers, auditors, regulators, and users of financial statements |

Congressman Oxley, former chairman of the House Committee on Financial Services and coauthor of the landmark Sarbanes-Oxley Act of 2002 (the Act), delivered one of the keynote addresses to kick off the Conference. Congressman Oxley, who is retiring this term after serving in Congress since 1981, indicated that two of the greatest short-term challenges facing our economy and country are maintaining the strength and competitiveness of the U.S. capital markets and threats to the capital markets from possible terrorist attacks.

The "tech bubble" burst of the late 1990s and the collapse of Enron and other major companies revealed significant flaws in the system and a need for much greater investor protection. Congressman Oxley believes that implementing the requirements of the Act has strengthened U.S. capital markets and increased investors' confidence. While he acknowledges that the costs of implementing Section 404 of the Act have been higher than anticipated, he indicated that there has been a noticeable change in corporate culture. Congressman Oxley expressed concerns about the difficulties for small public companies and foreign issuers that the implementation of Section 404 has caused and the impact that it may be having on the relative competitiveness of U.S. capital markets. He believes that additional guidance from regulators on implementing the Section 404 provisions of the Act will give some relief to small public entities and foreign filers.

Congressman Oxley also expressed concerns about risks to the U.S. capital markets from terrorism, noting that protecting our physical assets, financial services, and computer systems from attack is critical. He indicated that the passage of the Patriot Act, which provides for, among other considerations, specific tracking of terrorist financing, is a positive step in that direction.

# U.S. ACCOUNTING PRINCIPLES

## Speech by John W. Albert, *Senior Associate Chief Accountant*, Office of the Chief Accountant of the Securities and Exchange Commission

| Topics Covered | Affects |
|---|---|
| • Interaction between the SEC's Office of the Chief Accountant and the Enforcement Division | All SEC registrants |
| • SEC Rule 102(e) — suspension for improper professional conduct | Auditors of public companies and corporate accountants with decision-making responsibilities for financial reporting |

### Interaction Between the SEC's Office of the Chief Accountant (OCA) and the Enforcement Division

"Many of you may be less aware — some blissfully so — of the interaction between our Office and the SEC's Enforcement Division," stated Mr. Albert in his opening remarks. He emphasized that actions initiated by the Enforcement Division related to accounting and auditing matters are conducted in conjunction with OCA. In some cases, the results of this interaction, as well as OCA's other accounting work, uncover more than improper accounting. For example, the OCA is often asked to assess the propriety of the accounting for business combinations. In one instance, the staff challenged the purchase price allocation of an asset related to a non-compete agreement, specifically citing the enforceability of the agreement. The investigation took an unexpected turn, uncovering the misappropriation of corporate assets. Mr. Albert noted that insiders allegedly received corporate funds under the non-compete agreement, despite the fact that the agreement was never requested by the acquirer.

### SEC Rule 102(e) — Suspension for Improper Professional Conduct

Mr. Albert cited another important element of OCA's enforcement related activity: the consultation OCA provides on investigations related to improper professional conduct falling under Rule 102(e) of the SEC's Rules of Professional Practice. Mr. Albert stated that the consequences of violating this rule, applicable to auditors (with both active and inactive licenses) and corporate accountants alike, can result in punishments as severe as permanent suspension from practicing or appearing before the SEC. Mr. Albert noted that Rule 102(e) does not create an "unlevel playing field" for U.S. registrants compared to foreign registrants, as potential suspensions also apply to professionals licensed in foreign countries that prepare or audit financial statements filed with the SEC.

**Editor's Note:** Rule 102(e) of the SEC's Rules of Professional Practice describes the types of misconduct that can result in temporary or permanent suspension.

## Panel Discussion on Uncertain Tax Positions:

### Paul Beswick, *Practice Fellow*, Financial Accounting Standards Board

### Brett Cohen, *Partner*, PricewaterhouseCoopers LLP

### Jenifer Minke-Girard, *Senior Associate Chief Accountant*, Office of the Chief Accountant of the Securities and Exchange Commission

| Topics Covered | Affects |
|---|---|
| • Interpretation 48 | All SEC registrants and auditors of public companies |

### Interpretation 48

The panel discussed various issues relating to Interpretation 48.

**Disclosures**

Paragraph 21(d) of Interpretation 48 requires companies to disclose certain information regarding changes to the unrecognized tax benefit when the changes are reasonably possible to occur within the next 12 months, including an estimate of the range of the amount of change. Mr. Beswick clarified that the term "reasonably possible" has the same meaning in Interpretation 48 as it has in Statement 5: greater than remote but less than probable. Additionally, the panel noted that the estimated range of outcomes should not include all possible amounts but rather the smaller subset of reasonably possible amounts. An example was provided to illustrate this concept.

**Example**

Assume a company concludes that the range of all possible amounts is zero to $1 million and the range of all reasonably possible amounts is $100,000 to $500,000. In this situation, the company would disclose the range of reasonably possible amounts of $100,000 to $500,000.

Mr. Beswick also indicated that it may be acceptable to aggregate tax positions for the disclosure requirement in paragraph 21(d) of Interpretation 48; however, significant jurisdictions may need to be discussed separately. In addition, he noted that under paragraph 21(e), companies may have to disclose the tax years that remain subject to examination by significant individual states and foreign tax jurisdictions, including significant tax jurisdictions where nexus has been established but a tax return has not been filed.

Ms. Minke-Girard stated that SAB 74 disclosures would generally be expected to become more detailed as the effective date of Interpretation 48 gets closer. She also indicated that because the FASB intended for the disclosures required by the Interpretation to be annual disclosures, the SEC staff only will require the disclosures as of the date of the adoption to be carried forward to interim periods during the year of adoption, updated for any material changes. She noted that this treatment provides some relief to registrants, and that normally, if an accounting pronouncement is adopted in an interim period, the staff would expect all required disclosures to be provided in that interim period and updated for all subsequent periods until they are included in an annual period.

The panel remarked that companies should also consider providing additional disclosures in Management's Discussion and Analysis (MD&A) that describe the financial statement effects that resulted from adoption, including any expected changes in future trends in tax rates, expected cash flows, or other items. The panelists indicated that unrecognized tax benefits should be disclosed in the contractual obligations table in MD&A.

Mr. Cohen discussed his views on certain disclosures required by the Interpretation, on accounting for refunds and deposits, and on interest income. For instance, he noted that paragraph 21(a) of Interpretation 48 requires a rollforward of the unrecognized tax benefit on a world-wide, aggregate basis. He stated that in general, the unrecognized tax benefit is the difference between the tax position taken or expected to be taken in the tax return and the amount of benefit recorded in the financial statements. He also remarked that unrecognized benefits should be included on a gross basis in the rollforward, not net of any correlated benefit (e.g., the federal benefit that would be received if an uncertain state tax position was denied).

### Preferability Letters

Ms. Minke-Girard indicated that the SEC staff will not require a preferability letter for those registrants that change their accounting policy relating to the classification of interest and penalties upon adoption of Interpretation 48. However, a preferability letter would be required for changes in accounting policy occurring in periods after adoption.

### Interest and Penalties

Ms. Minke-Girard pointed out that companies that include interest expense as part of the income tax provision should calculate the expense (as described by paragraph 15 of Interpretation 48) and record the expense ratably over the year. She remarked that, accordingly, interest expense should be excluded from the effective tax rate calculation prescribed by Opinion 18. Acknowledging that this methodology may increase income statement volatility, she reminded registrants to use MD&A to address significant fluctuations and noted that the classification of interest and penalties should be consistent among the income statement, balance sheet, and statement of cash flows. Ms. Minke-Girard indicated that good disclosure regarding classification policies is necessary for comparability of financial statements between companies that apply different policies.

### Timing Differences

With respect to a filed tax position whose ultimate deductibility is certain, but in which uncertainty exists as to when the deduction may be taken, Mr. Beswick clarified that that tax position meets the recognition criteria of Interpretation 48. He noted that any uncertainty associated with that tax position should be addressed in its measurement, and that this does not suggest that such tax positions should be analyzed using a one-step model. He also indicated that companies are required to assess whether the tax position ultimately will be deductible based on its technical merits prior to measuring the associated tax benefit.

### Other Issues

As highlighted by Mr. Cohen, the Interpretation removes income taxes from the scope of Statement 5, including refund claims expected to be filed. He noted that accordingly, the recognition and measurement criteria under Interpretation 48 should be applied to refund claims expected to be filed. He also indicated that interest income should be recognized in the same manner and classified consistently with interest expense.

Finally, Ms. Minke-Girard noted that the Interpretation does not prescribe documentation requirements and that reasonable judgments regarding appropriate documentation need to be made by preparers and auditors.

## Panel Discussion on Valuation Techniques:

**Loretta Cangialosi, *Vice President and Controller*, Pfizer Inc**

**Don Charles, *Americas Director Valuation & Business Modeling*, Ernst & Young LLP**

**Craig Emrick, *Vice President–Senior Accounting Analyst*, Moody's Investors Service**

**Linda McDonald, *Director*, Financial Accounting Standards Board**

**Cheryl Tjon-Hing, *Valuation Specialist*, Office of the Chief Accountant of the Securities and Exchange Commission**

| Topics Covered | Affects |
|---|---|
| • Valuation techniques (Statement 157), including remarks made in a separate session regarding accounting for emission allowances | Entities with assets and liabilities measured at fair value; entities that carry emission allowances at fair value |

Ms. McDonald and Mr. Charles provided a brief overview of the recently issued Statement 157 (see Deloitte & Touche LLP's September 27, 2006, *Heads Up* on Statement 157, and see remarks of SEC staff member Joe McGrath regarding inception gains for additional information).

Ms. Cangialosi provided her perspective on issues that preparers and their auditors may face when implementing the requirements of Statement 157. She remarked that entities should consider many potential issues, including the following:

- Understanding the exit price notion.
- Identifying their principal (or most advantageous) market for each asset and liability.
- Understanding valuation techniques and inputs (including adjusting for risk).
- Preparing for the Statement's disclosure requirements and Sarbanes-Oxley Section 404 internal control considerations.
- Documentation needs.

Ms. Tjon-Hing observed that preparers, auditors, and valuation specialists are frequently unaware of the more subtle valuation requirements of U.S. GAAP. She highlighted the following two examples of circumstances that preparers and valuation specialists may overlook when performing fair value measurements:

*(1) Tax benefits related to depreciation/amortization* — Paragraph 129 of Statement 109 states in part that the "Board concluded that the amounts assigned to assets and liabilities in a purchase business combination should **not** be net of any related deferred tax liability or asset." [Emphasis added]

**Example**

Paragraph 129 of Statement 109 includes the following example: "assume (a) that the pretax market or appraisal value of depreciable assets acquired in a purchase business combination is $1,000, (b) that the tax basis of those assets is zero, and (c) that the enacted tax rate is 40 percent for all years. If net of tax, the assigned value of those assets would be $600. If pretax, the assigned value of those assets would be $1,000, and there would be a $400 deferred tax liability." Based on Ms. Tjon-Hing's remarks, the appropriate presentation is pretax. This is the case even when the amortization is nondeductible.

**Editor's Note:** Ms. Tjon-Hing's remarks regarding tax amortization benefits are consistent with the guidance found in Chapter 5 of the AICPA Practice Aid, *Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries*. The Practice Aid contains additional helpful examples.

*(2) Embedded derivatives* — Implementation Issue B15 highlights that paragraph 12 of Statement 133 does not permit an entity to separately account for more than one derivative feature embedded in a single hybrid instrument. That is, multiple derivatives (requiring bifurcation) embedded in a single hybrid instrument should be bundled together. The bundled embedded derivative would be bifurcated and accounted for separately from the host contract under Statement 133 unless a fair value election is made pursuant to Statement 155. Ms. Tjon-Hing indicated that the guidance in Implementation Issue B15 is fair value measurement guidance. The fair value of a bundled embedded derivative should be measured as a single derivative that would likely not equal the sum of the fair values of the individual embedded derivatives.

Mr. Emrick discussed some of the advantages and disadvantages of the provisions of Statement 157 and the proposed FASB Statement, *The Fair Value Option for Financial Assets and Financial Liabilities,* from the perspective of Moody's Investors Services (Moody's). He noted the following:

- Moody's and other users will benefit from the disclosures required by Statement 157. The disclosures provide useful information about fair value that cannot currently be obtained from financial statements. However, Moody's often performs sensitivity and other analysis on the key inputs that are driving fair value and will continue to do so after adoption of Statement 157. He believes that Statement 157's disclosures are a good first step towards more useful financial statements.
- Moody's has some concerns about the relevance of a fair value measurement in circumstances in which the entity's intended use of the item differs from the market participant assumptions used in the item's fair value measurement. In evaluating the relevance of fair value measurements, Moody's considers the following: (a) the proximity of settlement of the asset or liability, (b) the ability/intent of the entity to realize the fair value change, (c) the certainty of cash settlement (e.g., for derivatives), and (d) the basis on which the operations of the entity are managed (e.g., a "matched book" portfolio managed on a fair value basis).
- When analyzing financial statements, Moody's will make adjustments for entities that carry debt at fair value under the FASB's proposed Fair Value Option statement. The adjustments would reverse the fair value accounting and reflect the contractual amounts owed. These adjustments would be in addition to the four typical adjustments that Moody's makes to U.S. GAAP financial statements for analytical purposes. Those four adjustments are (1) expensing stock compensation (prior to Statement 123(R)), (2) capitalizing operating leases, (3) recording a liability for unfunded pension obligations (prior to Statement 158), and (4) unwinding certain securitization transactions.

**Editor's Note:** Ms. Shelly Luisi, associate chief accountant in the Office of the Chief Accountant of the Securities and Exchange Commission, responded to a question on the use of fair value to measure emissions allowances. Ms. Luisi stated that in her opinion, the only basis for carrying the emissions allowances at fair value would be if they were derivatives; however, she stated that she does not believe that is typically the case. In her opinion, the emissions allowances are more akin to intangible assets and, therefore, the use of fair value as a subsequent measurement attribute is inappropriate.

## Speech by Cathy J. Cole, *Associate Chief Accountant*, Office of the Chief Accountant of the Securities and Exchange Commission

| Topics Covered | Affects |
|---|---|
| • Two-class method of computing earnings per share | Entities with multiple classes of stock or other securities that may participate in dividends |

Statement 128 indicates that earnings per share (EPS) should be calculated following the "two-class method" in cases in which a class of common stock has dividend rights that differ from another class, as well as in cases in which securities other than common stock have a right to participate in dividends. While the requirement to follow a two-class EPS computation has been around for decades, and recent interpretive guidance in Issue 03-6 has helped provide some clarification, authoritative accounting literature includes little computational guidance. Ms. Cole believes that the two-class method is under-discussed and noted that the SEC staff has recently had several issues brought to its attention. Ms. Cole presented the fact pattern below concerning the computation of **diluted EPS** when participating common stock is convertible into another class of common stock.

### Example

Assume a company has two classes of common stock, Class A and Class B. Class A is entitled to $1.20 of dividends for every $1.00 of dividends paid to Class B, and Class B is convertible into Class A on a 1:1 basis at any time. Diluted earnings per share for Class A would be based on the more dilutive of the two-class method or the if-converted method. Although Class B would be entitled to a higher share of earnings on a diluted basis assuming conversion, because diluted EPS must be presented for each class, presentation of diluted EPS for Class B must be presented assuming conversion does not occur.

Ms. Cole noted that, although neither Statement 128 nor Issue 03-6 address the matter, the SEC staff expects that a company with two classes of common stock will present both a basic and diluted EPS number for each class of common stock, regardless of conversion rights. As indicated by Statement 128 and clarified by Issue 03-6, diluted EPS should be computed using the if-converted method for the nonconvertible class (the "converted into" class) if the effect is dilutive. Diluted EPS for the convertible class is computed using the two-class method as required by Statement 128 when there is more than one class of common stock and the classes have different dividend rates.

Ms. Cole pointed out that one may question the need to compute the diluted earnings per share for a convertible class of shares, because the presumed conversion (for purposes of calculating diluted EPS on the converted-into class) would hypothetically eliminate the second class of shares. Ms. Cole indicated that there are several reasons for presenting diluted EPS for the convertible class. First, paragraph 61(d) of Statement 128 requires the presentation of basic and diluted EPS data for each class when there are multiple classes of common stock. Second, as illustrated in the example above, in presenting diluted EPS for the converted-into class, the assumed conversion may be dilutive, but the assumed conversion might in fact be antidilutive for the convertible class. However, holders of the convertible class may want information regarding the diluted EPS on their investment in the absence of their conversion. This might be especially true in circumstances in which other dilutive securities (such as options, warrants, and convertible debt) would also affect the computation. She referred to this presentation as "double the numbers…double the fun."

Ms. Cole illustrated another two-class fact pattern in the following example.

### Example

Assume a company has issued two classes of common stock, Class A and Class B. Class A is entitled to one vote per share; Class B is entitled to ten votes per share. The company's articles of incorporation state that dividends can be paid on Class A without an equal, or any, dividend being paid on Class B. However, dividends cannot be paid on Class B without an equal amount being paid on Class A. Class B is convertible into Class A on a 1:1 basis at any time. Further, Class B common stock controls approximately 75 percent of the shareholder votes of the company. Classes A and B share equally in the net assets of the company on liquidation. The company has historically paid dividends equally to both classes. In applying the two-class method, the company has allocated the undistributed earnings equally on a per-share basis to both classes.

In this example, there is no contractually established ratio of participation for Class B common stock and, accordingly, if one were to apply the provisions of Issue 03-6 to this situation, there would be no allocation of earnings to Class B. In other words, all earnings can be entirely distributed to Class A without any distribution to Class B. However, Ms. Cole indicated that, as Class B common stockholders control the entity, it is unlikely they would permit the Board to pay dividends on Class A shares without making a distribution to Class B as well. Additionally, the fact that Class B is convertible into Class A would allow Class B holders to capture any disproportionate dividend by exercising their conversion rights.

In this case, Ms. Cole indicated that the SEC staff did not believe that a strict application of Issue 03-6 was appropriate. Rather, the SEC staff believes that Issue 03-6 was generally written in the context of classes of participating securities that do not control the company and that applying the EITF guidance by analogy in this case did not produce the most transparent reporting. Ms. Cole indicated that companies need to consider all of the rights and privileges of the classes to determine the allocation of undistributed earnings to the individual classes of common stock in applying the two-class-method to several classes of common stock. Accordingly, in the fact pattern above, the staff did not object to the company's judgment that earnings should be allocated to the two classes on a 1:1 basis.

**Editor's Note:** The FASB staff is currently working on two FASB staff positions: one on the application of the two-class method to employee compensation arrangements, and one on providing computational guidance for calculating diluted EPS under the two-class method. The FSPs are expected to be finalized in the first quarter of 2007.

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

| Topics Covered | Affects |
|---|---|
| • Materiality judgments | All preparers and auditors |

Mr. Hardiman discussed several questions regarding materiality judgments, including:

- Can large errors be immaterial?
- Can individually material errors be netted and thus considered immaterial?
- How should errors be evaluated in an interim period?

He began by stating that the overriding consideration in evaluating materiality of errors is that judgments must consider all relevant quantitative **and** qualitative factors.

### Can large errors be immaterial?

According to Mr. Hardiman, the short is answer is yes, but it is unlikely. SAB 99 lists certain qualitative considerations that can cause small errors to be considered material. Some entities have used these qualitative factors to evaluate large errors, postulating that large errors are immaterial in the absence of the qualitative factors set forth in SAB 99. Mr. Hardiman stated this would be inappropriate. The fact that the error does not, for example, affect debt covenants or executive compensation does not mean it is immaterial. For an entity to reach a conclusion that a large error is immaterial, it would need to identify considerations that cause the financial statements to be reliable notwithstanding the error. He provided the following example to illustrate how trends in financial performance may indicate a situation in which a quantitatively large error could be considered immaterial.

#### Example — Break-Even Years

Net Income / Loss

2001 — $100 million loss

2002 — $50 million loss

2003 — $100,000 income

2004 — $50 million income

2005 — $100 million income

Assume a $20,000 error in 2003 (represents 20 percent of net income)

In this situation, it may be appropriate to conclude that the error is immaterial even though quantitatively it would appear material. However, he cautioned that in this circumstance, determining the materiality of an error in a "break even" year would require judgment, particularly if the entity has thin margins or is involved in a turnaround situation.

### Can individually material errors be netted and thus considered immaterial?

Mr. Hardiman described a situation in which an entity has an individually material error that is offset by an error of equal magnitude and the entity concludes that the errors are — in the aggregate — immaterial. Mr. Hardiman stated that all errors should be evaluated **both** individually and in the aggregate. This evaluation would include consideration of the effect of the error on each financial statement line item, including subtotals and totals. If the individual error is determined to be material, irrespective of the impact of aggregation with other errors, the registrant would need to correct it. Regarding assessing errors, he specifically stated that "luck is not a qualitative factor that enters into materiality judgments." He suggested keeping in mind that all errors included in any cumulative-effect adjustment under SAB 108 would be required to be disclosed, including a description and quantification of each error.

**Interim Materiality**

Mr. Hardiman discussed the issue of how to evaluate errors in an interim period. He acknowledged the factors of diversity, differing opinions, and limited guidance on an appropriate method. He did not offer answers; rather, he encouraged the profession to continue the dialogue. He offered three alternatives for consideration:

- All errors should be evaluated against annual amounts.
- All errors should be evaluated against interim amounts.
- Prior period errors should be evaluated against annual amounts, while current period errors should be evaluated against interim amounts.

He listed pros and cons for the above methods. He postulated the following question to highlight a concern about any method that might de-emphasize the importance of interim information: would users of financial statements agree that an error in a quarter is immaterial to the quarter solely because the error is expected to be immaterial to the annual period? His answer: probably not. He also expressed a concern that the choice of any one of these specific methods could render the analysis too mechanical. That is, it could result in an analysis that focuses on specific quantitative factors instead of key qualitative factors.

**Editor's Note:** In a subsequent question and answer session, Scott Taub, deputy chief accountant, Office of the Chief Accountant of the Securities and Exchange Commission, addressed several questions from the audience related to materiality considerations. In response to one question, he stated that the SEC does not have a "rule of thumb" or a quantitative threshold that defines a "large error." He also addressed why SAB 108 did not address the quarterly materiality issue. Acknowledging the difficulty of the issue, Mr. Taub said that the staff felt it was important to get out without delay the annual assessment information included in SAB 108. The SEC staff has previously indicated that it continues to evaluate the issue of interim materiality assessments and that guidance may be issued.

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

| Topics Covered | Affects |
|---|---|
| • Impact of registration requirements on embedded conversion options, freestanding warrants, and share forwards | Entities that issue securities with equity conversion or settlement rights (e.g., convertible debt, warrants), whether freestanding or embedded |

### Impact of Securities Law on Liability/Equity Classification

At last year's conference, Todd Hardiman, associate chief accountant in the SEC's Division of Corporation Finance, discussed the complexity in determining the appropriate accounting for embedded conversion options and freestanding warrants. Ms. Hunsaker indicated that the SEC staff, in addition to noting improvements in the application of Issue 00-19 since last year, continues to focus on (1) whether such instruments constitute equity and (2) an issuer's accounting for the related securities. She also discussed an issuer's ability to deliver unregistered shares and the impact of securities law.

Ms. Hunsaker points out that to classify many conversion options, freestanding warrants, and similar instruments as equity, an issuer must be able to settle the arrangement in unregistered shares (unless the issuer need not apply paragraphs 14–18 of Issue 00-19, such as with "conventional convertible debt"). An issuer must therefore determine whether it is able to issue unregistered shares.

According to Ms. Hunsaker, in evaluating whether it can issue unregistered shares, an entity must examine the legal requirements of the Securities Act of 1933 (the Act). The Act requires the registering of all offers and sales of securities unless there is an exemption for the offer and sale. Accordingly, unless an exemption is available, an entity is required to deliver **registered** shares. Ms. Hunsaker cited private placements (offerings that are not public) as a common example of an exemption from the requirement to issue registered shares.

**Editor's Note:** Securities that fail to meet the criteria discussed in Issue 00-19 must be classified as a liability and measured at fair value (with changes in fair value recognized in the income statement).

Ms. Hunsaker discussed the Act's "transactional nature," noting that it applies to the offer-and-sale transactions involving the securities rather than to the securities themselves. Therefore, in a transaction involving multiple securities, an entity must evaluate both the initial offer and the individual sales/settlements of the securities. Accordingly, an entity must consider the method in which the security is offered **and** settled when evaluating whether an exemption exists.

In a public offering of securities (e.g., sale of a warrant in a public offering), subsequent settlement (e.g., delivery of a share upon exercise of a warrant) in registered shares will usually be required.

**Editor's Note:** In evaluating whether a transaction meets the exemption requirements outlined in the Act, an entity should consult with its securities counsel.

According to Ms. Hunsaker, determining whether an issuer is able to deliver unregistered shares can be complex, requiring a comprehensive understanding and analysis of securities law. She highlighted that to evaluate fully the registration requirements of a security, the issuer must consider both the contractual and legal registration requirements. If the underlying contract requires the issuer to deliver registered shares, such registration would be considered outside the control of the issuer until all such registration actions are complete.

Consider the following example:

**Example**

In a public offering, Company X (X) offers "units" consisting of one share and one warrant. From a securities law perspective, X is offering (1) shares in the units, (2) warrants in the units, and (3) shares of stock underlying the warrants. Because the initial offering is a public offering, X cannot avail itself of the private placement exemption for the subsequent delivery of unregistered shares upon exercise of the warrants. As a result, X must deliver registered shares to settle the warrants (i.e., delivery of unregistered shares would violate securities laws). The warrant does not qualify for equity classification unless the prospectus explicitly states that if X cannot deliver registered shares, non-settlement (i.e., no delivery of cash or shares) is an acceptable alternative.

### Relief in Sight Related to Registration Rights and Liquidated Damages Clauses

As Ms. Hunsaker pointed out in the above discussion, an issuer, unless exempt, must be able to settle in unregistered shares to achieve equity classification. Because of this requirement, registration rights agreements that include a liquidated damages clause commonly accompany the issuance of equity instruments, warrants, and other convertible securities. Typically, such agreements require the issuer to use its "best efforts" to register the underlying shares. If an issuer fails to have shares registered in a given grace period, the issuer is required to pay damages to the investor.

Questions had been raised about whether such arrangements were derivatives under Statement 133 and whether they affected a conclusion that the accompanying security was properly classified as equity. Ms. Hunsaker noted that the proposed FSP EITF 00-19-b will provide some relief to issuers. The proposed FSP requires that a contingent obligation (damages payment), resulting from the probable failure to obtain (or maintain) an effective registration statement, be recognized and measured separately in accordance with Statement 5 and Interpretation 14. The underlying financial instrument(s) to be registered shall be recognized and measured in accordance with other applicable GAAP (e.g., Opinion 21, Statement 133, and Issue 00-19), without regard for the contingent obligation.

**Editor's Note:** In discussing recent Issue 00-19 matters, Ms. Hunsaker noted that when evaluating the embedded conversion option in convertible preferred stock, issuers must consider the nature of the preferred stock (i.e., the "host" contract). Issuers need to consider paragraph 61(l) of Statement 133, which states, in part, "the terms of the preferred stock (other than the conversion option) must be analyzed to determine whether the preferred stock (and thus the potential host contract) is more akin to an equity instrument or a debt instrument." She noted that such consideration should include an evaluation of the redemption provisions, the nature of returns, voting rights, collateral rights, participation, preference in liquidation, and the presence of creditor rights (i.e., whether the holder can force bankruptcy).

Ms. Hunsaker concluded that if preferred stock is considered equity, no further analysis of bifurcation is required. However, she added, if preferred stock is more akin to debt, the same analysis as that required for convertible debt must be performed.

The proposed FSP would be effective immediately for registration payment arrangements entered into or modified subsequent to the issuance date of the FSP. The guidance would apply to existing arrangements in fiscal years beginning after December 15, 2006. In the meantime, most registrants are following one of the approaches outlined in Issue 05-4. Registrants should disclose the accounting policy in their financial statements.

Finally, Ms Hunsaker noted that the FASB staff is researching alternatives to improve the operability and reduce the complexity of the current liability/equity classification guidance in Issue 00-19.

## Panel Discussion on Option Backdating and Statement 123(R):

### Chad Kokenge, *Partner*, PricewaterhouseCoopers LLP

### Allison T. Spivey, *Associate Chief Accountant*, Office of the Chief Accountant of the Securities and Exchange Commission

| Topics Covered | Affects |
|---|---|
| • Status report on option backdating<br>• Statement 123(R) | Entities that grant employee share-based payment awards |

### Status Report on Option Backdating

With stock option backdating affecting many companies, Ms. Spivey and Mr. Kokenge provided insight into some of the more common issues and questions they encounter. Noting that backdating activities were predominantly occurring before 2002, the panelists observed that changes in legal requirements initiated by the Sarbanes-Oxley Act of 2002 may have helped mitigate these activities. They noted that because many of the questionable granting practices extend back four or more years and the underlying historical documentation may be inadequate, some companies are struggling to find answers when addressing the accounting for historical options grants.

The following table summarizes some common issues:

| Issue | Remarks |
|---|---|
| If documentation to support historical options grants is inconclusive, missing, or conflicting, can entities default to the worst-case scenario in determining the accounting measurement date? | The SEC staff encourages, but does not require, registrants to preclear alternative measurement date approaches. While preclearances enable the staff to understand the issue better, they do not necessarily give registrants a definitive answer on their alternative approach. Instead, the staff reminds companies of their responsibilities under both SEC regulations and the associated accounting guidance. The staff's one consistent message has been that there are **no default answers**. Accordingly, entities must consider all available evidence in determining the appropriate measurement date.<br>Once entities have determined their measurement dates with finality, based upon all of the available evidence, additional disclosures may be required. |
| If stock option modifications were made during the granting process, what is the impact on the determination of a grant date? | A common situation involves the Compensation Committee approving a pool of assigned grants; however, prior to the final issuance of the grants to the employees, modifications were made to certain awards. Such a situation raises questions about whether the awards, as approved by the Compensation Committee, were approved with finality (thus establishing a measurement date in accordance with Opinion 25). Companies have questioned whether they can separate the pool between the grants that remained fixed and those that were modified. The panelists indicated that it depends on the facts and circumstances surrounding the grant (a common theme throughout the discussion). Companies should examine their own granting practices and consider whether and when the appropriate authority was received and whether the terms of an award were known with finality. |

| Issue | Remarks |
|---|---|
| If grants are deemed to be issued outside the option plan (the terms of the award are inconsistent with the requirements of the underlying plan document), what is the impact on the accounting for the award? | One example is when an entity's plan indicates that option grants cannot be issued in the money. In this example, the validity of these prior grants may be in question if, in hindsight, such options are now deemed to have been issued in the money. Question 18 of Interpretation 44 states that in general, "shareholder approval must be obtained in order to conclude that a grant (and a measurement) date for an award has occurred under Opinion 25." In light of Interpretation 44, questions have been raised about whether the guidance of Interpretation 44 would preclude both a grant and a measurement date under Opinion 25. The staff indicated that to the extent entities have been honoring these awards, the substance of the arrangement may support the conclusion that such awards should be considered granted and that the terms are established with finality. (This conclusion is predicated on Section C of the letter that the Office of the Chief Accountant issued on September 19, 2006, which discusses existing accounting guidance on the granting of stock options, specifically the validity of prior grants.) Once entities have determined their measurement dates with finality, based upon all of the available evidence, additional disclosures may be required. |
| Can an entity use SAB 108 as an alternative in accounting for a correction of prior-year errors related to backdating activities? | SAB 108 does not directly address the backdating of options; as a result, entities should consider the guidance in SAB 99 in evaluating whether a restatement is necessary. To the extent the prior-year errors are considered immaterial (after both a qualitative and a quantitative assessment of the error), it may be appropriate to use SAB 108 to account for the effects of the backdating corrections. |
| What are the implications of backdating the exercise date (as opposed to the grant date)? | Recent press has focused on the backdating of the exercise date of options for tax purposes. For many options, employees are taxed on the basis of the intrinsic value of an award at the date of exercise and the employer will receive a deduction for the same amount. Backdating the exercise date to a date when the share price is lower results in the employee's reporting lower taxable income and the employer's receiving a smaller deduction. The accounting for stock option exercises that were backdated to obtain preferential tax treatment for the employee depends on the facts and circumstances. However, if the employer substantively has provided an additional benefit to the employee, recognition of additional compensation cost would generally be required. In addition, there are likely to be issues associated with improperly reporting such amounts to the taxing authorities. |

**Editor's Note:** In an earlier session, John Albert, associate chief accountant in the Office of the Chief Accountant of the Securities and Exchange Commission, cited two particularly egregious examples of fraudulent stock option backdating:

- In one case, backdating option grant dates became a regular part of the company's recruiting incentives. The Commission alleged that employment offer letters and compensation committee minutes were falsified to such an extent that the false dates preceded the date the employees were hired.
- In another instance, the Commission alleged that a "slush" fund was created by the granting of at-the-money options to fictitious employees, locking in grants for which no compensation expense was recorded (because the exercise price was equal to the strike price). These options were used later to recruit and retain employees.

## Statement 123(R)

The panelists also commented on the application of Statement 123(R), noting the following:

| Issue | Remarks |
| --- | --- |
| Can the "simplified method" for calculating expected term (as discussed in SAB 107) be applied to grants after December 31, 2007? | Consider the following example:<br>Company X's current fiscal year ends on January 31, 2008. Company X has chosen to apply the "simplified method" described in SAB 107 to determine the expected terms of its vanilla options. Is it appropriate to apply the simplified method for option grants during the month of January 2008?<br>The simplified method was intended to provide temporary relief in order to allow companies more time to collect empirical data. SAB 107 states that the simplified method should not be used for share option grants after December 31, 2007. Accordingly, Company X cannot use the simplified method for any grants made after December 31, 2007, regardless of its fiscal year end. |
| Is it acceptable to substitute the prior day's closing stock price for the quoted market price on the grant (measurement) date in measuring compensation cost? | Companies using the prior day's closing price in assigning a grant date exercise price should do this consistently to all grants. For example, if a company were to use the price on the grant date as the strike price when it is lower than the prior day's closing price, this might indicate the company's manipulation of the exercise price. On the other hand, if a company uses such a practice consistently it may represent an acceptable accounting convention. |

## Speech by Timothy S. Kviz, *Professional Accounting Fellow*, Office of the Chief Accountant of the Securities and Exchange Commission

| Topics Covered | Affects |
|---|---|
| • Application of Statement 133 — issues involving hedge effectiveness | Entities that apply Statement 133 hedge accounting |

### Application of Statement 133 — Issues Involving Hedge Effectiveness

Mr. Kviz stated, "Despite the fact that Statement 133 has been in place for over five years, hedge accounting continues to be a significant source of formal and no-name inquiries, is a contributing factor for a significant number of restatements, and generates a large number of articles in the press."

Mr. Kviz noted that to apply hedge accounting under Statement 133, the hedging relationship must be highly effective in achieving offsetting changes in fair value or cash flows attributable to the risk being hedged, both at inception of the hedge and on an ongoing basis. He added that entities must demonstrate this effectiveness both retrospectively and prospectively. Mr. Kviz also reminded participants that the FASB granted several exceptions to this periodic effectiveness assessment and measurement requirement in response to constituent concerns that performing retrospective and prospective assessments of hedge effectiveness on certain types of straightforward relationships was too burdensome. The exceptions include:

- The shortcut method.[6]
- The critical terms match method.[7]
- Two methods of measuring hedge ineffectiveness under Implementation Issue G7.

Mr. Kviz discussed how these exceptions have been misapplied in practice.

#### Shortcut Method

Mr. Kviz noted that the shortcut method was developed for hedges of interest rate risk involving interest rate swaps and recognized interest-bearing assets or liabilities (e.g., debt instruments). He expressed that its use is limited to relationships that meet the nine criteria set forth in Statement 133. Mr. Kviz also noted that "media reports notwithstanding, the staff **does** believe that there are relationships that qualify for the shortcut method." However, he emphasized that the shortcut criteria cannot be satisfied "in spirit" — that all nine of the criteria must be exactly met.

He cited two examples in which the staff indicated its belief that the shortcut method had been misapplied:

- *Trust preferred securities* — Trust preferred securities typically contain an interest deferral feature. The staff believes that hedging relationships involving instruments having this feature are ineligible for the shortcut method. Some registrants contended that the deferral feature could be ignored when assessing eligibility for the shortcut method, as they did not intend to exercise the deferral option. Mr. Kviz stated that the staff does not believe that this feature can be "assumed away." The feature is designed to satisfy regulatory requirements and is substantive. Other registrants believed shortcut eligibility could be obtained by mirroring the option in the hedging interest rate swap. He noted that the staff also rejected this approach, believing the deferral feature violates the shortcut requirement that the formula for computing net settlements be the same for each net settlement.

- *Cash flow hedge of variable rate debt that includes a call option permitting the debtor to repurchase the debt at par at the interest reset date* — Typically, in a hedging relationship involving callable or puttable instruments, the hedging interest rate swap must contain a mirror call or put option to qualify for the shortcut method.[8] Mr. Kviz indicated that some argued that interest rate swaps hedging variable rate debt, callable at par on the interest reset date, need not contain a mirror option, pointing to Implementation Issue E6. Under this theory, it is asserted that the call option has a fair value of zero since the call occurs on the interest reset date. Mr. Kviz noted this assumption would not be true because it is atypical for the call

[6] See paragraph 68 of Statement 133.
[7] See paragraph 65 of Statement 133.
[8] See paragraph 68(d) of Statement 133.

price to be adjusted for changes in credit sector spreads and the debtor's creditworthiness. Accordingly, the liability would be considered prepayable, and the shortcut method could not be applied unless the prepayment option was mirrored in the hedging interest rate swap, which would not be typical for such hedges.

**Editor's Illustration**

Company X issues, at par, bullet maturity, five-year variable rate debt at 75 basis points over LIBOR. Company X can call the debt at par at any interest reset date. Six months after issuing the debt, Company X exercises its call. During the six months the debt had been outstanding, credit spreads had narrowed and Company X's creditworthiness had improved. Consequently, Company X can now refinance the debt for LIBOR plus 50 basis points. The example illustrates that the call option had value to Company X.

Although the application of the shortcut method is not appropriate in the examples above, Mr. Kviz acknowledged that it is quite possible that the hedging relationships would be deemed highly effective if a full effectiveness assessment under the long-haul method had been performed. See Quantification of Errors in the Assessment of Hedge Effectiveness below for further discussion.

### Critical-Terms-Match Method and Statement 133 Implementation Issue G7 Methods

Mr. Kviz also discussed other methods of assessing hedge effectiveness that include an assumption of no ineffectiveness, namely (1) the critical-terms-match method and (2) two methods of measuring hedge ineffectiveness discussed in Implementation Issue G7. He noted that all of these methods are based on the principle that when all known sources of variability are perfectly matched, there is no need to perform a significant amount of work to evaluate whether the hedge is highly effective or to measure the ineffectiveness. He stated that continued application of those methods requires ongoing assessments of whether the critical terms of the hedged item and hedging instrument have changed or whether there have been adverse credit-related developments with respect to the counterparty of the hedging instrument. Mr. Kviz emphasized, however, that **it is inappropriate to apply a method that simply assumes no ineffectiveness to those hedging relationships in which known sources of variability that could create ineffectiveness exist.** Examples he cited include:

1. The critical-terms-match approach may not be available for a fair value hedge of an interest rate exposure using an interest rate swap. In a theoretical perfectly effective fair value hedge, changes in the fair value of the hedged item would be exactly offset by changes in the fair value of the hedging instrument. That perfect fair value offset would likely be achieved only if both participants in the hedge had identical credit ratings (i.e., the premium they would pay over the risk free interest rate was identical). If the creditworthiness of the two counterparties differs, it is likely there will be differences in the changes in fair values of the two instruments from period to period due to changes in credit spreads, which creates ineffectiveness as a result of imperfect offset.
2. The critical-terms-match approach is not appropriate in a hedging relationship in which the settlement dates of the forecasted transaction and the hedging instrument differ. Differences in settlement dates create ineffectiveness that should be measured and recognized in the income statement.
3. When a basis difference is created due to differing payment dates on variable-rate debt and an interest rate swap, the assumption of no ineffectiveness under the change in variable cash flows method of Implementation Issue G7 would not be appropriate. A lack of basis difference is necessary to assume no ineffectiveness under this method.

Mr. Kviz noted that registrants often inquire about the amount of work that must be performed to prove that any ineffectiveness that exists in hedging relationships, such as those discussed above, will be immaterial, thereby allowing an assumption of no ineffectiveness in the hedging relationship. He stated that the staff believes that in most situations, it is inappropriate to rely on intuition alone to support an assumption of no ineffectiveness on the basis of immateriality. There have been past circumstances, however, in which the staff has accepted recording no ineffectiveness when an entity has identified a source of ineffectiveness but concluded that the amount of ineffectiveness would be de minimis. Mr. Kviz noted that in these instances, the registrants' conclusions of immaterial ineffectiveness were supported by an evaluation of the possible impacts of the ineffectiveness under a variety of realistic market scenarios. He stated that such analyses should be documented and clearly demonstrate a continuing and reasonable expectation of effectiveness.

**Editor's Note:** Many companies hedge the cash flow variability associated with forecasted foreign currency denominated sales. One strategy involves using a currency forward that settles on a single day within a month, but whose notional amount relates to sales expected to occur during the entire month. Mr. Kviz's presentation raises questions about the suitability of using the critical-terms-match method for these hedging relationships.

### Quantification of Errors in the Assessment of Hedge Effectiveness

Mr. Kviz reiterated that the error resulting from the misapplication of the shortcut method or an incorrect assumption of no ineffectiveness generally should be computed by comparing what was recorded to what would have been recorded had hedge accounting not been applied at all — **even if the hedge would have been found to be effective under the long-haul method of assessing hedge effectiveness**. The error should not be computed as simply the amount of ineffectiveness that would have been recognized under the long-haul method. He stated that this conclusion is based on the premise that compliance with Statement 133 requirements had been deficient since hedge inception. That is, because the registrant erroneously had assumed no ineffectiveness, it would have failed the requirement to document the retrospective and prospective assessments of hedge effectiveness and to perform the required periodic measurement of hedge ineffectiveness.

However, if a company believes that the error computed under this approach is inappropriate or unfair, Mr. Kviz suggested that its management contact the SEC staff.

## Speech by Mark Mahar, *Associate Chief Accountant*, Office of the Chief Accountant of the Securities and Exchange Commission

| Topics Covered | Affects |
|---|---|
| • Materiality and SAB 108 | All SEC registrants and auditors of public companies |
| • Application of Interpretation 46(R) and Issue 04-5 | Companies with general partner/limited partner arrangements |
| • Professional judgment in accounting decisions and auditor independence | All preparers and auditors of financial statements |

### Materiality and SAB 108

The SEC staff issued SAB 108 to address diversity in practice as it relates to the quantification and materiality of prior-year errors. Mr. Mahar reiterated that SAB 108 does not alter the staff's interpretation of SAB 99, nor is it intended to "be a free pass to clean up balance sheets." He discussed the following two frequently asked questions:

- Assume prior-year errors are determined to be immaterial after being quantified under the SAB 108 approach. In the initial year of the SAB's application, can such errors be included in the cumulative-effect adjustment at the beginning of the year?
  - Mr. Mahar noted that prior-year errors may be determined to be individually immaterial in accordance with SAB 108, and that therefore, these errors generally would not be included in the cumulative-effect adjustment. However, if the registrant and the auditors determine that the immaterial errors, when aggregated with other material or other individually immaterial errors, are material, then inclusion in the cumulative-effect adjustment may be appropriate. Keep in mind, however, that each and every error still needs to be disclosed.
- If a registrant elects to retroactively adjust prior-period financial statements for immaterial errors, are those financial statements required to be labeled as restated with mention in the auditor's report and is the filing of an Item 4.02 Form 8-K required?
  - Mr. Mahar noted that immaterial errors, by definition, are not believed to affect investors' decisions. Therefore, the registrant should use reasonable judgment, in consultation with its legal counsel and auditors, to determine whether such information or communications are required. He indicated, however, that "[i]t seems the real question is how to meet the objective of clear and transparent financial reporting by providing sufficient disclosure of the changes and the reasons why the changes are necessary."

**Editor's Note:** In a subsequent question-and-answer session, Scott Taub, deputy chief accountant in the office of the Chief Accountant of the SEC, addressed several questions about SAB 108. Many of the questions concerned the ability to record immaterial errors in the cumulative-effect adjustment. Mr. Taub indicated that the cumulative-effect adjustment applies to situations in which a registrant identified an error in a prior year, quantified the error using its pre-SAB 108 error evaluation method, and determined the error to be immaterial. However, when the registrant uses the SAB 108 method to quantify the error in the current year, it is now determined to be material, either individually or when aggregated with other such errors. In these situations, the prior-year error can be corrected through the cumulative-effect adjustment. He further noted that by using the cumulative-effect adjustment, the registrant "is essentially agreeing that either individually or in the aggregate they have some material errors under the SAB 108 methodology."

For more information on SAB 108, see Deloitte & Touche LLP's September 18, 2006, *Heads Up* and October 17, 2006, SEC Alert 06-2.

## Application of Interpretation 46(R) and Issue 04-5

Mr. Mahar discussed consolidation practices involving Interpretation 46(R) of which the SEC staff has become aware. He indicated that certain general partner (GP)/limited partner (LP) arrangements are being structured to be tacitly within the scope of Interpretation 46(R) to allow the GP to circumvent the consolidation provisions of Issue 04-5. By circumventing the provisions of Issue 04-5, the GP may avoid consolidating the partnership entity. Mr. Mahar made the point that "using professional judgment is not a cover or license to engineer around the intent of accounting literature." To illustrate this point, he described the following arrangement:

**Example**

A partnership includes a GP that makes no or only a non-substantive investment in the entity and the LPs have no kick-out rights. However, at least one of the LPs is a related party of the GP (related party in this context is defined by paragraph 16 of Interpretation 46(R) and paragraph 24 of Statement 57).

Mr. Mahar noted that if the GP considers its relationship with the entity in isolation, it might conclude that the entity is a variable interest entity (VIE) under Interpretation 46(R) because the holders of the equity investment at risk, the LPs, cannot make decisions about the entity's activities that significantly affect its success (paragraph 5(b)(1) test). Further, the GP might conclude that it does not have to consolidate the VIE because it does not absorb a majority of the expected gains or losses and thus is not the primary beneficiary.

Mr. Mahar stated that he believes this would be an incomplete analysis and that the GP should consider the significance of its relationship with the LP investors and whether that relationship would result in the GP and LP being considered a related-party group. This analysis will depend on facts and circumstances and will require a high degree of professional judgment. If the GP and LP are considered a group, their interests would be combined, thus likely passing the paragraph 5(b)(1) test in Interpretation 46(R). The entity would not be considered a VIE, and the GP would apply Issue 04-5 and consolidate the partnership.

Mr. Mahar stated that "it's attempts like this that often lead to restatements and more accounting standards as the standard setters seek to close the door on abusive transactions."

## Professional Judgment in Accounting Decisions and Auditor Independence

Consistent with one of the main themes of the conference, Mr. Mahar discussed the necessity of applying professional judgment in both accounting and auditor independence matters. He noted that although some issues are black and white, certain situations require professionals to use and accept judgment. While judgment is necessary in preparing, auditing, and understanding high-quality financial statements, he acknowledged that it is sometimes second-guessed. Mr. Mahar concluded that a process for considering, assessing, and documenting all relevant facts and conclusions, and disclosing such conclusions when material, should greatly mitigate the risk of being second guessed.

Concerning auditor independence, Mr. Mahar noted that audit committee discussions should not "evolve into an annual rubber stamp event." Rather, what was discussed and decided should be transparent. Finally, he reminded the audience that the OCA provides an avenue for preclearing more complex judgments in order to alleviate the need for a review by other divisions of the SEC. Information regarding the protocol for consulting with the OCA can be found on the SEC's Web site.

## Speech by Joseph D. McGrath, *Professional Accounting Fellow*, Office of the Chief Accountant of the Securities and Exchange Commission

| Topics Covered | Affects |
|---|---|
| • Fair value<br>• Derivative inception gains | Derivative and commodity dealers |
| • Arrangements with multiple accounting components | Companies that enter into arrangements with multiple accounting components |
| • Accounting for inventory | Derivative and commodity dealers |
| • Revenue recognition and transfers of financial assets | Companies that transfer rights to future cash flows |
| • Hedge documentation | Companies that apply hedge accounting |

### Fair Value: Derivative Inception Gains

Although Statement 157 nullifies footnote 3 of Issue 02-3, Mr. McGrath warned that it is "not open season" on recognition of inception gains on derivatives. Footnote 3 had prohibited inception gains for certain derivatives in the absence of observable data supporting the valuation technique (see Deloitte & Touche LLP's September 27, 2006, *Heads Up*, for more information on Statement 157). Given Statement 157's exit price notion, fair value at initial recognition is no longer limited to transaction price. Rather, Statement 157 states that the entity "shall consider factors specific to the transaction and the asset or liability." One such factor is whether the transaction occurs in a market other than the entity's principal market as the Statement illustrates in Example 7.

According to Mr. McGrath, Statement 157 does not permit gain recognition on "marking to model" for transactions occurring in the entity's principal market. Transaction prices are generally appropriate for such transactions. If a securities dealer transacts with another dealer in the dealer market without the satisfaction of any of the criteria in paragraph 17 of Statement 157, transaction price would generally be the best estimate of fair value, which would preclude recognition of any inception gains or losses.

**Example**

Broker-Dealer A enters into two interest rate swap transactions, both with a transaction price of zero. Swap 1 is with a corporate customer; swap 2 is with another broker dealer in derivatives. According to Mr. McGrath, absent satisfaction of any other criteria in paragraph 17 of Statement 157, inception gain or loss is precluded on swap 2 because the dealer transacted in its principal market. Inception gain or loss is not precluded on swap 1 because the dealer transacted in the retail market and the transaction price would not necessarily represent the fair value of the swap.

A model used to determine fair value should be calibrated such that its calculation of fair value equals the transaction price when that represents fair value (swap 2 in the above example).[9] Mr. McGrath further cautioned that the use of a calibrated pricing model to determine fair value would not result in "day two gains," unless changes occurred in the underlying market conditions.

9 This is consistent with footnote 18 of Statement 157.

**Editor's Note:** These aspects of Statement 157 are complex. At a later question-and-answer session, Ms. Shelly Luisi, senior associate chief accountant in the Office of the Chief Accountant of the SEC, indicated that Mr. McGrath had been discussing inception gains and losses in the context of model values with unobservable inputs. She further indicated that differences between an entry and exit price within the bid/offer spread, if observable, may be a factor in determining fair value. If so, entities should use the price within the bid/offer spread that is most representative of fair value for the entity's particular circumstances, provided that it is used consistently.

### Fair Value: Arrangements With Multiple Accounting Components

Mr. McGrath noted that the staff has encountered a number of instances in which transactions or agreements contained multiple elements that were not subject to specific authoritative literature. Examples include contract termination agreements, executory contracts containing modifications to existing contracts that may require an up-front payment (see example below), and a litigation settlement that requires future services or other concessions between the parties. The arrangements are often complex, and the accounting depends on the specific facts and circumstances. Mr. McGrath indicated that the same two fundamental questions exist with respect to all of these examples: (1) whether the arrangements should be separated into two or more elements for accounting purposes and (2) if so, how the elements should be measured.

Mr. McGrath indicated that in determining whether to separate an arrangement into two or more elements for accounting purposes, constituents should consider whether:

- The elements have independent economic value or substance.
- Any one element would meet the definition of an asset or liability.
- There are instances in which similar elements would be purchased or sold individually.
- The company has a reasonable basis for making an allocation among the elements.

Mr. McGrath also stated that the substance of the transaction should again be considered in determining how each element should be measured. The staff believes that fair value is a more appropriate basis for allocation than the stated amounts in the contract, even when the arrangement specifically states amounts for a given element in the contract.

**Example**

Entity A (A), the customer, terminates a long-term contract with Entity B (B), the vendor, and pays $1,000 at the time of termination. As part of the termination agreement, B will provide A with transition services for six months at a negotiated rate of $100 per month. Assuming that the fair value of B's services is $80 per month, A should record a settlement loss of $1,120 (the $1,000 initial payment plus six months of the service payments in excess of the fair value of B's services).

### Fair Value: Accounting for Inventory

Mr. McGrath encouraged us all to "stay tuned" to the issue of measuring commodity inventory at fair value. The staff has received numerous inquiries about whether it is appropriate to record inventory at fair value. Although the use of fair value continues to become more widespread, inventory measurement is still subject to Chapter 4 of ARB 43, which states, in part, "Only in exceptional cases may inventories properly be stated above cost. For example, precious metals having a fixed monetary value with no substantial cost of marketing may be stated at such monetary value." In accounting for inventory at fair value, the following criteria must be present: (1) inability to determine approximate cost, (2) immediate marketability at quoted market prices, and (3) the characteristic of unit interchangeability. In most situations, including those involving commodity inventories, registrants can determine the inventory's approximate cost. Thus, it would be rare that a registrant would satisfy the ARB's criteria that would allow for fair value measurement.

Mr. McGrath reminded registrants that Chapter 4 of ARB 43 takes precedence over industry practice. Therefore, measuring inventory at fair value on such a basis is not permitted. Some registrants have cited industry practice or other generally accepted accounting principles, such as those in the AICPA Auditing and Accounting Guide, *Brokers and Dealers in Securities*, as support for measuring inventory at fair value. Although the SEC has not formulated a view on this issue, Mr. McGrath noted that measuring inventory at fair value would require additional standard setting to eliminate any conflict with Chapter 4 of ARB 43. The EITF[10] has been asked a similar question — whether entities within the scope of the *Brokers and Dealers* guide should account for physical commodity inventory at fair value.

10 The EITF discussed Issue 06-12 at its November 16, 2006, meeting. The Task Force did not reach any tentative conclusions and requested that the FASB add a project discussing whether traded physical commodity inventory should be carried at fair value.

**Editor's Note:** At a later question-and-answer session, Ms. Luisi indicated that although the SEC is aware that there is diversity in practice, it has not asked broker-dealers that are measuring their commodity positions at fair value to restate their previously issued financial statements to correct an error.

### Revenue Recognition and Transfers of Financial Assets

Mr. McGrath noted that the staff is aware of instances in which registrants, unable to satisfy the revenue recognition criteria that apply to a certain transaction, transferred the rights to the transaction's future cash flows, asserting that they achieved sale accounting in accordance with Statement 140. While the facts and circumstances of any transaction must be considered, transferors often inappropriately characterize these transfers as sales of trade receivables.

Generally, Mr. McGrath pointed out, the first step in evaluating the accounting for such an arrangement is to determine whether revenue and a corresponding receivable should be recognized. If revenue recognition is predicated on accounting for the transfer as a sale, revenue recognition is likely inappropriate and the right to the underlying cash flows is likely not a receivable for accounting purposes. Since Statement 140 only applies to transfers of recognized financial assets (such as receivables), this type of arrangement seems more appropriately characterized as a financing transaction — similar to a sale of future revenues pursuant to Issue 88-18. Mr. McGrath reminded registrants of the guidance in TIS Section 5100.42 on software revenue recognition that deals with extended payment terms that are transferred or converted to cash without recourse to the vendor.

### Hedge Documentation

Finally, Mr. McGrath discussed hedge documentation issues. While Statement 133 requires formal documentation of a hedging relationship at the inception of the hedge, it does not prescribe the form of documentation. He noted that the staff has accepted many different approaches — as long as each required element is documented. Because there is no bright line for determining whether a hedge relationship is sufficiently clear, companies and their auditors must use judgment in evaluating the sufficiency of the documentation.

Mr. McGrath remarked that a group of individual transactions that are part of one hedging relationship are required to be sufficiently homogeneous.

**Example**

Assume that forecasted sales of commodities, though part of a group, have different delivery locations. A company may need to perform additional analyses to support its assertion that the commodities in the group share the same exposure.

Mr. McGrath indicated that the staff has seen an increase in questionable scenarios involving whether individual transactions within a group share the same risk exposure as required by paragraph 29 of Statement 133 for forecasted transactions. How the similarity of the hedged items must be demonstrated has not been specified. Sometimes the similarities will be easily documented; other times, the task will be more difficult. In conclusion, Mr. McGrath noted that if the composition of the group of similar transactions changes, the company periodically may be required to update its analysis throughout the life of the relationship.

## Speech by Jeffrey D. Mechanick, *Project Manager*, Financial Accounting Standards Board

| Topics Covered | Affects |
|---|---|
| • Statement 158 overview and implementation questions | Sponsors of defined benefit pension and other postretirement plans |

With the effective date of the recognition and related disclosure provisions of Statement 158 rapidly approaching for many public companies (years ending after December 15, 2006),[11] Mr. Mechanick gave a brief overview of the Statement's major provisions, focusing on implementation questions received by the FASB staff since the Statement's issuance. The following summarizes Mr. Mechanick's remarks.

### Funded Status

If a company's measurement date is not aligned with its balance sheet date, the postretirement asset or liability recognized at year end may not necessarily equal the previously measured funded status. Companies will need to update the postretirement asset or liability for certain events that take place between the plan's measurement date and the company's year-end date, such as contributions or benefit payments.

### Early Adoption of Measurement Date Provisions by December 31, 2006

The FASB staff does not believe that a company could use the paragraph 18 transition method, which requires a measurement of plan assets and benefit obligations both at the beginning and at the end of the year in which the measurement date provisions are adopted. However, they are still considering when it might be appropriate to early-adopt under the paragraph 19 transition method, which only requires the measurement of plan assets and benefit obligations at the end of the year in which the measurement date provisions are adopted.[12]

### Timing of Retained Earnings Adjustments in the Year the Measurement Date Provisions Are Initially Applied

Statement 158 does not say whether, when using the paragraph 19 transition guidance to adopt the Statement's measurement date provisions, a company should record the required retained earnings adjustment to the opening or closing balance. Mr. Mechanick indicated that the FASB staff does not object to either approach.

**Editor's Note:** Regardless of whether the adjustment is recorded to the opening or closing balance of retained earnings, a company should consider additional disclosure required under SAB 74 regarding the known impact on retained earnings in the company's filings, covering periods prior to the recording of the adjustment. If the adjustment is made to the closing balance of retained earnings in the year of adoption of the measurement date provisions, the requirement for SAB 74 disclosures continues in interim period filings (e.g., during 2008 for a calendar-year-end entity that adopts the measurement date provisions for its fiscal year ending after December 15, 2008).

### Calculation of the Additional Minimum Liability Prior to Adoption

The recognition of an additional minimum pension liability is no longer necessary once companies recognize the full funded status of a plan in the balance sheet. However, Mr. Mechanick reminded preparers that paragraph 20 of Statement 158 requires companies to disclose the incremental effect of applying the Statement on individual balance sheet line items. Therefore, companies will need to calculate the additional minimum liability in the year of adoption to prepare this disclosure.

### Accounting for Statement 112 Plans

An entity that measures accumulating benefits for a plan accounted for under Statement 112 by analogizing to Statement 87 or Statement 106 should apply the guidance of Statement 158 when it becomes effective. Upon the adoption of Statement 158, use of the accounting models in the pre-amended Statements 87 and 106 would no longer be appropriate.

[11] Statement 158's recognition and disclosure provisions will be effective at the end of 2006 for calendar-year-end companies with publicly traded equity securities, as defined in paragraph 11 of the Statement.

[12] For more information about Statement 158's transition methods for adopting the measurement date provisions, see Deloitte & Touche LLP's October 5, 2006, *Heads Up*.

Ms. Jenifer Minke-Girard, a senior associate chief accountant in the Office of the Chief Accountant at the SEC, agreed and added that entities applying Statements 87 and 106 by analogy to Statement 112 plans also should consider the disclosure requirements of Statement 132(R). If analogous disclosures were not made when accounting for Statement 112 plans, **registrants should consider consulting the SEC to determine whether such practices would result in the need to correct an error**.

### Accounting for Equity Method Investments

Statement 158's measurement date provisions require that a company with an investment accounted for under the equity method measure the investee's plan assets and benefit obligations as of the date of the investee's financial statements used to apply the equity method. This could be as early as three months prior to the investor's year-end balance sheet date. As a result, the equity method investee may have to perform multiple plan measurements in a given year.

**Example**

An equity method investee and its investor each have a calendar year end. Based on the timing of the availability of the equity method investee's financial statements, the investor accounts for its equity method investment on a one-month lag (i.e., the investor uses the equity method investee's November 30 financial statements to record its equity pickup in its December 31 financial statements). In this scenario, the equity method investee is required to measure its plan assets and benefit obligations as of November 30 for purposes of the investor's financial statements and again as of December 31 for its own stand-alone financial statements.

### Use of Convenience Date to Measure Plan Assets and Benefit Obligations

A question from the audience related to whether a company that has a 52/53-week year could measure its plan assets and benefit obligations by using the closest month-end date (e.g., companies with a 52/53-week year whose fiscal year end in a given year is January 3 would perform the measurement as of December 31). Mr. Mechanick responded that the answer would technically be no: the company should measure its plan's assets and benefit obligations as of its actual year end (in this example, January 3). From the standpoint of convenience, however, he indicated that companies may be able to follow the suggested approach if differences between the two measurement dates would not result in a material difference in the financial statements.

### Other Matters

Ms. Minke-Girard also addressed a question from the audience concerning how MD&A might change upon the adoption of Statement 158. A registrant should consider including the liability recorded for underfunded plans in its table of contractual obligations, as well as disclosing (1) the changes in funding requirements that affect liquidity and (2) the impact that Statement 158 will have or has had on debt covenants or other agreements entered into by the company.

In a separate session, Mr. Larry Smith, director of technical application and implementation activities at the FASB, commented that some companies may be required to capitalize a portion of their postretirement benefit costs in accordance with other generally accepted accounting principles (e.g., when a company uses its employees to construct its own asset). However, he noted that any gain or loss recognized from the effects of a plan settlement or curtailment should not be capitalized but recognized in earnings.

## Speech by Leslie A. Overton, *Associate Chief Accountant*, Division of Corporation Finance of the Securities and Exchange Commission

| Topics Covered | Affects |
|---|---|
| • Form and content of financial statements in an IPO<br>• Push-down accounting | Entities engaged in an IPO involving the merger of entities under common control |

Given the recent trend in private equity transactions, Ms. Overton focused on a typical exit strategy for investors in these transactions, which combine entities under common control just prior to or simultaneous with an initial public offering (IPO). In assessing the IPO reporting and accounting issues associated with these types of transactions, the registrant needs to determine the financial statements required in the registration statement. To make this determination, she indicated that the four key questions discussed below should be addressed.

**Should the combination of the entities under common control be reflected in the historical financial statements or only in the pro forma financial statements of the combined entity?**

Ms. Overton noted that the SEC staff believes that the combination of entities under common control in conjunction with an IPO should only be reflected in the historical financial statements if either of the following conditions is present: (a) the merger has occurred or (b) the combined entities will become a consolidated group by the IPO effective date and the transactions will be accounted for as a reorganization of entities under common control. If neither condition is present, the consolidation of entities should only be reflected in the pro forma financial statements. If the merger is reflected in the pro forma financial statements, these statements should be provided for the same periods as the historical financial statements (that is, the latest three fiscal years and any subsequent interim period) and should retroactively reflect the combination as a change in reporting entity similar to a pooling of interests for all periods that common control existed.

Other adjustments associated with the merger or IPO (e.g., other business acquisitions accounted for as a purchase, acquisitions of minority interest, change in capital structure as a result of the transaction, and changes in financing) should be presented in the pro forma financial statements only for the latest year and interim period as required by Article 11 of Regulation S-X.

Ms. Overton also noted that if an existing registrant files a registration statement that is not an IPO after a common control merger has occurred, but the post-merger results have not yet been published, the registrant may be required to file supplemental audited financial statements reflecting the merger.

> **Editor's Note:** See additional guidance on supplemental financial statements for a transaction accounted for in a manner similar to a pooling of interests in the September 2004 minutes of the AICPA SEC Regulations Committee Joint Meeting with the SEC Staff.

**Which entities' financial statements are required in the registration statement? That is, who is the parent, which of the combining companies is the predecessor, and are any pre-acquisition financial statements required under Rule 3-05 of Regulation S-X?**

Irrespective of whether the combination will be reflected in the historical financial statements or the pro forma financial statements, the registrant should assess which entities' financial statements are required in the registration statement. To answer this question, Ms. Overton noted that it is first necessary to determine the parent of the entities under common control in the transaction, as well as the predecessor entity of the registrant going public. With regard to the parent, the SEC staff believes that an entity, an individual, or a group of individuals meeting the definition of a control group under Issue 02-5 may be the parent. Although parent financial statements may not be required in the registration statement, determination of who the parent entity is affects the financial statement determination.

**Editor's Note:** In a later question-and-answer session, Mr. Olinger clarified that the parent of the commonly controlled companies in the timeframe prior to the combination is considered the parent for the purpose of financial statement determination. The parent could be a venture capital or private equity firm that controls the underlying business and will not be part of the combining companies. Accordingly, the parent's assets, liabilities, operations, and cash flows may not be included in the historical financial statements or the pro forma financial statements.

Next, Ms. Overton indicated that it must be determined which of the combining entities represents the predecessor to the registrant. The predecessor in the transaction will generally be the entity first acquired or controlled by the parent of the entities that are to be combined. Financial statements of the predecessor should be filed for the same periods as they would if the predecessor were a registrant, as required by Rules 3-01 and 3-02 of Regulation S-X, even if the predecessor were not controlled by the parent for all such periods.

**Editor's Note:** In a later question-and-answer session, clarification was provided on Ms. Overton's comment that the predecessor is generally the first entity acquired or controlled. There may be instances in which multiple transactions are in process at the same time and a smaller transaction closes a short time before a larger, more significant transaction on which the investor intended to build the business. In those situations, the larger entity may represent the predecessor even though it is not the first entity acquired. In addition, there may be multiple predecessors when there are multiple on-going transactions that make it difficult to identify a single predecessor. For companies having difficulty identifying a single predecessor, the SEC staff will generally not object to providing financial information for multiple predecessor entities.

If an entity is determined to be a predecessor, additional information would be required, such as a description of the business, selected financial data, and management's discussion and analysis under Items 101, 301 and 303 of Regulation S-K, respectively.

In addition to predecessor financial statements, Ms. Overton noted that financial statements of significant combining entities may be required under Rule 3-05 of Regulation S-X for periods before being acquired by the parent. Financial statements of a business acquired directly by one of the combining companies during the periods presented may also be required. Significance under Rule 3-05 should be measured against the combined entity at the acquisition date if the merger is reflected in the historical combined financial statements; otherwise, it should be measured against the predecessor's financial statements. Ms. Overton also noted that an alternative to the significance test required by Rule 3-05 is available pursuant to SAB 80 and may provide some relief from the financial statement requirements, as significance is measured against the pro forma combined company at the time of the IPO. This alternative is only available if the criteria in SAB 80 are met, such as if the combined entity is created by the aggregation of discrete businesses that remain substantially intact after acquisition.

Ms. Overton also noted that because the financial statements only reflect the combination on an as-if pooled basis for periods after control was acquired by the parent, financial statement requirements for periods prior to common control existing must be assessed.

### How should the financial statements be presented?

The combined financial statements of the entities under common control, whether included as historical financial statements or pro forma financial statements, should reflect the assets, liabilities, operations, and cash flows of the entities only from the date the entities were under common control of the parent. Although the parent's financial information may not be included in such statements, Ms. Overton indicated that the SEC staff believes that any equity interests not acquired by the parent should be reflected as minority interests on the combined balance sheet and combined income statement of the merged entities. If the merger has not been completed before effectiveness of the IPO, the capital structure and earnings per share (EPS) of each of the combining entities should be disclosed on the face of the financial statements or in the notes. If the merger has been completed, EPS should be retroactively restated for all periods to reflect the change in capital structure unless there are significant cash distributions in the merger. If there are significant cash distributions, pro forma EPS should be presented for the latest year and interim period only.

### What is the appropriate application of Statement 141 and push-down accounting?

After addressing which financial statements are required and the form of those statements, Ms. Overton reviewed the application of Statement 141 and push-down accounting to the transactions. As indicated in paragraph 11 of Statement 141, transfers of net assets or exchanges of equity interests between entities under common control are not business combinations.

Accordingly, the net assets should be recorded at historical cost (i.e., the parent's historical cost to the extent of its ownership in each entity). Ms. Overton pointed out that if cash is paid to the parent, or if the non-stock consideration paid for the transferred assets differs from the parent's historical basis in the assets, the cash or consideration should be treated as a dividend to the parent. Conversely, if cash or non-stock consideration is received by the combined companies, it should be accounted for as a contribution to capital by the parent.

Registrants should refer to Technical Bulletin 85-5 for guidance on whether purchase accounting should be applied to the minority interest. In addition to the criteria in Technical Bulletin 85-5, it is necessary to have objective and reliable evidence of the value of the issuer's shares exchanged in the merger in order to apply purchase accounting. Given the absence of specific guidance for valuing shares in a common control merger, Ms. Overton stated that it would be reasonable to analogize to Issue 99-12 even though the merger does not meet the definition of a business combination. However, because an agreement date may not exist for mergers of entities under common control, the valuation date will depend heavily on the facts and circumstances of the merger. In valuing the shares, evidence may be obtained from prior share transactions, prior valuations proposed in conjunction with intervening events, or the trading value of publicly traded combining company stock relative to its exchange ratio.

In addressing whether the parent's basis should be pushed down to the separate financial statements of a combining company (that is an SEC registrant) when a push-down basis was used in the combined financial statements, Ms. Overton referred to the guidance in Topic D-97 and SAB Topic 5.J. She further indicated that if the parent initially chose not to apply push-down accounting to the subsidiary, the SEC would permit it to subsequently elect to push down its basis in a combining entity's separate financial statements, even in the absence of a change in ownership or significant event. This is a relatively recent change in the SEC's position (as communicated at the April 5, 2005, AICPA SEC Regulations Committee meeting), stemming from its belief that push-down accounting is preferable in all circumstances.

**Editor's Note:** Topic D-97 indicates that push-down accounting to a subsidiary's separate financial statements is required if 95 percent or more of the subsidiary has been acquired (unless the company has outstanding public debt or preferred stock that may impact the acquirer's ability to control the form of ownership of the company), permitted if 80 percent to 95 percent has been acquired, and prohibited if less than 80 percent has been acquired.

When the parent does not control the form of ownership (i.e., it cannot control whether the acquired company continues to exist or is merged into the parent due to significant outstanding public debt or preferred stock), push-down accounting may not be required in a subsidiary's separate financial statements, even if the subsidiary is substantially wholly owned. Additionally, Ms. Overton indicated that some companies have argued against push-down accounting based on a notion that the subsidiary's other public security holders previously made investment decisions based on the historical financial statements that did not reflect push-down accounting. Ms. Overton indicated that the SEC believes this to be a weak argument because the same argument could be made for almost any change in the historical financial statements and because the SEC believes that push-down accounting results in a preferable presentation.

**Impairment Considerations for Long-Lived Assets and Goodwill**

Ms. Overton concluded her remarks by discussing the impairment of combining company assets. In the combined financial statements, an impairment of long-lived assets and goodwill should be recognized in the same amount and time period as they would be if the parent prepared consolidated financial statements. She cautioned against entities recognizing "Day 2" impairment losses after a reorganization and acquisition of minority interest. The foundation for this position is that the parent's basis in the assets is generally recorded at carryover value, which is typically lower than its current fair value, and only the minority interest is recorded at fair value. Therefore, it is uncommon to have a book value in excess of fair value immediately after the merger.

## Speech by Carol A. Stacey, *Chief Accountant*, Division of Corporation Finance of the Securities and Exchange Commission

| Topics Covered | Affects |
|---|---|
| • Analyzing statements of cash flows | Companies presenting a statement of cash flows |

Ms. Stacey noted that the staff of the SEC's Division of Corporation Finance, in its reviews, continues to focus on the statement of cash flows because of its importance to analysts and investors. She stated that many believe that the statement of cash flows is a better representation of an entity's financial activities and that it is less easily manipulated than the income statement.

Ms. Stacey indicated that Statement 95 establishes three broad categories of cash flows that reflect the major activities of a company — operating, investing, and financing — and provides guidance on what types of cash flows should be classified in those categories. She remarked that although this guidance creates meaningful cash flow groupings and promotes comparability in cash flow classifications among companies, it does not address every possible cash flow a company might encounter.

Ms. Stacey emphasized that when the appropriate cash flow classification is unclear, registrants must use judgment. She stated that such judgment should be supported by sufficient analysis, and could be subject to challenge by the SEC staff, noting that in many cases a thoughtful and objective review of the definitions, principles, and basis for conclusions in Statement 95 should indicate the appropriate classification. She also stated that other cash flows may require an even more careful analysis that considers, among other things, the nature of the activity and the predominant source of the cash flow for the items. In these difficult situations in which different cash flow classifications could be appropriate, or when there is diversity in practice, she indicated that companies should quantify and disclose (1) where the cash flow has been classified and (2) the alternative classifications considered and rejected.

### Example

Statement 95 does not provide specific guidance on how to classify changes in restricted cash in the statement of cash flows. For most entities, changes in restricted cash represent investing activities; however, in certain instances, the nature of an entity's business operations may indicate that another cash flow classification is appropriate. For example, a university may receive cash for a Pell Grant, which represents restricted cash. If the student receiving the grant leaves the university, the cash must be returned to the government. Since the nature of the activity and the predominant source of the cash flows relate to the university's operations (i.e., student tuition), it may be acceptable to classify changes in restricted cash related to the Pell Grant in operating activities rather than in investing activities.

## Speech by Scott A. Taub, *Deputy Chief Accountant*, Office of the Chief Accountant of the Securities and Exchange Commission

| Topics Covered | Affects |
|---|---|
| • Applying professional judgment in financial reporting | All preparers and auditors of financial statements |

In what likely will be the last speech in his current role, outgoing Deputy Chief Accountant Scott Taub focused on the importance of judgment required by preparers and auditors. Although many accountants are reluctant to apply judgment, in part because of a fear of being second-guessed in today's environment, Mr. Taub pointed out that even rules-based standards require difficult judgments — albeit of a different type than those required by objectives-oriented standards. He quoted the 2003 SEC staff report on objectives-oriented accounting standards,[13] which states the following:

> [I]n applying rules-based standards, professional judgment is needed to determine where within the numerous scope exceptions and conflicting guidance the company's transaction falls. Indeed, in many respects, the exercise of judgment in an objectives-oriented regime is merely different than under a rules-based regime.

The existence of both types of standards in current GAAP often causes confusion. Nonetheless, preparers and auditors cannot ignore bright lines within current literature; Mr. Taub reassured the audience that neither would the SEC staff. Accordingly, he said, "we will ask you to capitalize the lease even if you just barely went over the 90% threshold....On the other hand, we won't ask you to capitalize a lease that has minimum lease payments equal to 89% of the fair value of the leased asset, even though it would seem to be better accounting..."

Although many are calling for more principles-based standards, Mr. Taub noted that the accounting community often hesitates to apply them as such when they are issued. He pointed to last year's concern with Issue 03-1, which discussed when impairments of financial assets were other than temporary. Mr. Taub indicated that the Issue did not contain bright-line measures and that it required judgment. He remarked that in applying the Issue, some preparers and auditors tried to apply a bright line (involving whether the sale of an underwater security "tainted" remaining holdings) despite the lack of an explicit tainting notion. The Issue was eventually withdrawn owing to confusion regarding its application.

**Editor's Note:** On November 3, 2005, the FASB issued FSP FAS 115-1/FAS 124-1. While preserving the disclosure requirements of Issue 03-1, these FSPs nullified many of the Issue's recognition and measurement provisions.

Mr. Taub is also concerned about a tendency to seek the "safest" answer or to provide an answer as a "default" position. For example, he has heard assertions about a so-called documentation requirement under Interpretation 48 stating that without detailed documentation, a company is precluded from recording a benefit — even for "obvious" tax deductions. Mr. Taub stated that Interpretation 48 has no such default provision. He indicated that the race to the "safe" answer either by not recording the tax benefit or by rigorously supporting obvious positions will engender bad financial reporting or useless work.

**Editor's Note:** Interpretation 48 does not have a documentation requirement in order to record the benefit of a tax position. Companies should have adequate processes, procedures, and controls in place to ensure the proper implementation of Interpretation 48. Generally, as the validity of a tax position becomes more uncertain, the more documentation related to a company's assessment of that position would be expected.

According to Mr. Taub, "When the literature says to use a best estimate, or to consider available information, or to assess the likelihood of something occurring, those are all cues to evaluate the information and use judgment, and we must all be comfortable with that."

[13] *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System*, dated July 25, 2003.

Finally, Mr. Taub gave suggestions for dealing with the staff on an issue:

> First, spend some time thinking about significant issues before you file your financial statements. We wind up agreeing with a registrant's accounting a much higher percentage of the time when it turns out the registrant identified the issue, thought about the accounting, and documented its considerations at the time the transaction occurred. Second, if you believe the SEC staff isn't giving due consideration to your analysis, ask for the involvement of senior reviewers, or the front office in the Division of Corporation Finance, or even for the views of the Office of the Chief Accountant.

## Speech by Joseph B. Ucuzoglu, *Professional Accounting Fellow*, Office of the Chief Accountant of the Securities and Exchange Commission

| Topics Covered | Affects |
|---|---|
| • Purchase price allocations<br>  • Unfavorable revenue contracts<br>  • Customer relationship intangible assets | Companies that acquire businesses |
| • Option grants with administrative delays | Companies that issue stock options |
| • Special classes of stock granted to employees | Companies that use special classes of stock to compensate employees |
| • Postretirement benefit plan amendments | Companies with pension and other postretirement benefit plans |

### Purchase Price Allocations

**Unfavorable Revenue Contracts**

Mr. Ucuzoglu remarked that in some instances, Statement 141 requires the acquirer in a business combination to recognize an unfavorable contract liability for certain preexisting contracts such as in-process revenue contracts. He noted that this requirement occurs, for example, when the terms of a preexisting revenue contract are less favorable than the terms that would be negotiated in a current transaction. Accordingly, the recording of an unfavorable contract liability related to the transaction allows the post-acquisition financial statements to reflect a rate of return on the contract appropriate for the acquirer's remaining performance effort.

Mr. Ucuzoglu indicated that the evaluation of an acquired contract should focus on events occurring and changes in market conditions between the date of contract origination and the date of the acquisition. In the absence of intervening changes, the SEC staff will raise questions as to whether an acquired revenue contract was in an unfavorable position. Additionally, Mr. Ucuzoglu stated that the assumptions used to determine the current market rate of return for a similar contract should reflect those of an actual transaction in a competitive bidding environment, not those used as a starting point in contract negotiations (such as list prices).

**Customer Relationship Intangible Assets**

Mr. Ucuzoglu quickly dispelled a rumor regarding customer relationship intangible assets acquired in a business combination, a topic seemingly discussed annually at this conference (see remarks at the 2005 conference by Pamela R. Schlosser, professional accounting fellow in the SEC's Office of the Chief Accountant). He indicated that the SEC staff has heard suggestions that the use of an income approach to value customer relationship intangible assets is required, and that as long as a registrant characterizes its valuation method as an income approach, the staff would not challenge the specific assumptions or results. He emphasized that this is not the case. While an income approach is often the most appropriate valuation method, different circumstances may indicate that alternative methods provide a better estimate of fair value. Additionally, he noted that the SEC staff may question the reasonableness of the assumptions used in developing an estimate under the income approach.

Mr. Ucuzoglu remarked that in valuing a customer relationship intangible asset, the first step should be to understand why customers become repeat customers of the acquired entity. Some customers are naturally "sticky" (that is, they stay with the same vendor over time without frequently reconsidering their purchasing decisions). This stickiness indicates increased value in the customer relationship intangible asset. On the other hand, in cases in which the acquired company operates in an environment of high competition and frequent vendor turnover, Mr. Ucuzoglu stated that the value of the customer relationship intangible asset may be less. In other situations, the acquired company may maintain customers due to important factors such as brand recognition and proprietary technologies. Mr. Ucuzoglu remarked that in such cases, while the value of the customer relationship might not be as significant, it would be expected that the amount attributed to other intangible assets (e.g., tradename) would be commensurately higher to reflect the ability of those assets to generate income.

## Option Grants With Administrative Delays

Mr. Ucuzoglu referred to a letter that the Office of the Chief Accountant issued on September 19, 2006, that acknowledged that the possibility of reaching a measurement date under Opinion 25 prior to completing all of the administrative procedures necessary to affect the grant of a stock option is possible. However, he noted that for options issued subsequent to the adoption of Statement 123(R), the accounting literature is quite clear on the importance of completing certain corporate governance procedures prior to achieving a grant date. For example, for options issued subject to approval by the Board of Directors, Statement 123(R) states that a grant date is not reached until such approval is obtained. Accordingly, granting practices may have different effects on the determination of the measurement date under Opinion 25 versus that under Statement 123(R).

**Editor's Note:** Deloitte & Touche LLP's September 28, 2006, *Heads Up* discusses the SEC staff's letter.

Mr. Ucuzoglu also noted that accounting questions regarding stock option grants appear to occur less frequently in well-controlled environments. Accordingly, he stated that companies should pay special attention to internal controls around stock option granting processes to ensure they are in full compliance with the company's corporate governance provisions, the terms of stock option plans, and all applicable laws.

## Special Classes of Stock Granted to Employees

Mr. Ucuzoglu commented that the SEC staff has recently noted an increase in the number of public and pre-IPO companies, across a broad range of industries, granting special classes of stock solely to employees. He indicated that use of these instruments sparks consideration of a number of accounting issues. Most important is the determination of whether the instrument granted is equity or whether the arrangement is more similar to a performance bonus or profit sharing arrangement. Mr. Ucuzoglu noted that in considering the accounting, one should look beyond the "legal form" of the agreement. Rather, the "instrument" granted should be specifically analyzed to consider factors such as the rights to underlying assets, whether the instrument is subordinated, voting rights, dividend rights, and other features that would limit the "down side" risk of the holder. Mr. Ucuzoglu stated that there are no bright line tests to determine the appropriate classification of the instrument. All relevant features of the instrument should be considered.

For instruments classified as equity for accounting purposes, Mr. Ucuzoglu indicated that Topic D-98 often requires the instruments to be classified outside of permanent equity in the balance sheet, and that Issue 03-6 requires the presentation of earnings per share in accordance with the two-class method. Additionally, registrants need to consider the appropriate valuation of the instruments in accordance with Statement 123(R).

**Editor's Note:** The FASB staff recently released for comment FSP EITF 03-6-a, which will provide further clarification on determining whether instruments granted in share-based payment transactions are participating securities. The comment period ended December 19, 2006.

## Postretirement Benefit Plan Amendments

Mr. Ucuzoglu remarked that recently, the SEC staff has observed many companies making changes to their pension and postretirement benefits in an attempt to reduce the related obligations and mitigate costs, risk, or both. This is often accomplished through a series of interrelated actions that reduces or eliminates the benefits offered under certain arrangements while enhancing benefits of other arrangements.

Mr. Ucuzoglu noted that from an economic standpoint, the increases and decreases to these arrangements might naturally offset in a manner in which the net amount of the change represents the true impact of the employer's benefit obligations. However, he indicated that as a result of the deferred recognition provisions of Statements 87 and 106, certain changes are recognized over a future period, while changes in other benefit arrangements are reflected in income immediately.

He illustrated the importance of considering changes as a whole and the need to appropriately reflect the economic substance of a series of interrelated benefit plan changes in the following example:

### Example

A company reaches an agreement with its employees to forgo paying a presently due bonus that the employees have earned, and in return increases the benefits payable under its pension plan by an equivalent amount. If the two actions are viewed in isolation, the elimination of the bonus accrual would be reflected as an immediate gain in the income statement, while the benefit enhancement in the pension plan would be reflected as prior service cost and amortized over a future period. That accounting does not reflect the underlying economic substance of the agreement.

Mr. Ucuzoglu stated that the SEC staff pointed to examples within FASB Staff Implementation Guides to Statements 87, 88, and 106 that illustrate situations in which immediate recognition of income for part or all of the change in the obligation under a defined benefit plan should be considered. Under that guidance, in some cases in which plans are amended concurrently with other compensation changes, it may be appropriate to immediately recognize the impact of a change in a retirement obligation rather than defer the effect and recognize it over future periods.

Also, Mr. Ucuzoglu noted that the appropriate accounting for plan amendments depends on whether the affected plan is a defined contribution or defined benefit plan. Unless a postretirement plan meets the provisions of Statements 87 and 106 to be considered a defined contribution plan, it is a defined benefit plan. Such was the case in an example Mr. Ucuzoglu provided. Although an employer was at risk only for the amounts contributed to the new plan, there was no allocation of contributions to individual accounts. The absence of individual participant accounts resulted in a conclusion by the SEC staff that the new plan should be accounted for as a defined benefit plan.

**Editor's Note:** The FASB recently released Statement 158, which will affect certain measurement, recognition, and disclosure provisions of Statements 87 and 106. Deloitte & Touche LLP's October 5, 2006 *Heads Up* discusses Statement 158.

Mr. Ucuzoglu closed his remarks by noting that the Pension Protection Act of 2006 (the Act) may materially impact a company's benefit plan funding obligations. He stated that, in a manner consistent with SEC Financial Reporting Release 72, registrants should provide transparent disclosure in Management's Discussion and Analysis of the Act's anticipated impact on the company's liquidity and capital resources. Although it will be difficult to forecast precise funding requirements due to the annual recomputation required by the Act, Mr. Ucuzoglu indicated that it will often be possible to provide disclosure of the magnitude of cash commitments for future annual periods assuming present market conditions remain constant.

# SEC MATTERS

## Speeches by:

**Tom Church, *Partner,* Deloitte & Touche LLP**

**Jeff Naumann, *Enabling Technology Specialist,* Office of the Chief Accountant of the Securities and Exchange Commission**

**Campbell Pryde, *Managing Director,* Morgan Stanley**

**John Stantial, *Director of Financial Reporting,* United Technologies Corporation**

**Liv Watson, *Vice President of Global Strategies,* Edgar-Online**

**Mike Willis, *Partner,* PricewaterhouseCoopers LLP**

| Topics Covered | Affects |
|---|---|
| • XBRL overview and in-depth panel discussion | All SEC registrants |

Consistent with last year's conference, XBRL was a frequently mentioned topic. In February 2005, the SEC established a voluntary filing program that allows registrants to furnish voluntarily any or all of their periodic SEC filings by using the XBRL format. In January 2006, the SEC announced a new test group pilot program for registrants who commit to furnishing financial data contained in their periodic reports in XBRL format for at least one year. Participants in the pilot program will provide feedback on their experiences, including the costs and benefits associated with reporting in the interactive data format. For registrants that participate in the pilot program, the SEC staff will perform expedited reviews of registration statements and notify participants early if their Form 10-K has been selected for review. To date, more than 50 SEC registrants have participated in the voluntary filing program and over two dozen in the pilot program.

XBRL is a data tagging language for enhancing financial reporting. Data in an SEC filing prepared in XBRL format is assigned a predefined data tag. A group of data tags makes up an XBRL taxonomy. For instance, a GAAP XBRL taxonomy is made up of a series of data tags for commonly used accounts and elements in GAAP financial statements. The result of the tagging process is the creation of "machine readable" documents from which information can be directly extracted, compared, and analyzed across different filings or companies without the need to reenter or otherwise format the information. The SEC is working with XBRL International, a not-for-profit consortium, to develop GAAP taxonomies by industry. This would allow virtually all registrants to prepare their SEC filings in XBRL format by mid-2007.

XBRL is expected to reduce the time and resources companies spend in the financial reporting process through its ability to automate functions such as manual reviews and data input activities. Mr. Stantial noted that XBRL could "streamline the [financial reporting] process, strengthen internal controls, enhance delivery of products to customers and has a high potential to take out significant amounts of manual labor and level the playing field between investors and investees."

In September 2006, the SEC announced an investment of $54 million to overhaul the current EDGAR public company disclosure system. The new system is expected to include significantly enhanced searches of reports prepared with interactive data technologies such as XBRL. Of this investment, $5.5 million has been allocated for the completion of GAAP XBRL taxonomies. In addition, the SEC recently launched its Interactive Financial Report Viewer, which allows users to interact with XBRL documents submitted by participants in the voluntary filing program.

**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 is also available on the SEC's Web site.

Mr. Stantial noted that "cost is not an issue to participating in XBRL" and indicated that the technology's benefits and efficiencies far outweigh the investment of resources and the cost. He encouraged other registrants to begin furnishing documents in XBRL format to eliminate the learning curve associated with the technology. Mr. Stantial also believes that registrants should establish processes and controls for preparing documents in XBRL format before facing time pressures if the SEC mandates it. Finally, he noted that there are additional uses for the technology and encouraged other registrants to begin exploring the capabilities the technology might bring to their organizations.

The panel noted that the investment community will be a primary beneficiary of XBRL. XBRL results in information that is more transparent, useful, and comparable and allows analysts and other users to spend less time collecting data and more time analyzing the data. It is also expected to increase the number of companies that receive analyst coverage, allowing for increased exposure for registrants who prepare their filings in XBRL format.

The panel noted that the use and acceptance of XBRL in Canada and the United States is currently behind other international exchanges and global capital markets. XBRL is more widely used and accepted in Europe and Asia (China mandates that all regulatory filings be made in XBRL format). While the SEC does not currently mandate the use of XBRL, it is expected that as XBRL is further developed and registrants recognize the potential capabilities, cost savings, efficiencies, and usefulness of the technology, they will choose to file their reports in XBRL format.

A question currently being considered by the AICPA XBRL Task Force relates to the type of assurance that can be provided by auditors on XBRL documents. The panel noted that guidance currently exists in Attestation Standards Section 101, as well as in a Q&A document prepared by the PCAOB[14] that specifically addresses questions about attest engagements regarding XBRL financial information furnished under the voluntary filing program. In addition, the Assurance Working Group of XBRL International has prepared a white paper titled "Interactive Data: the Impact on Assurance, New Challenges for the Audit Profession,"[15] which discusses the challenges of XBRL and the role of the auditor.

[14] The PCAOB Q&A is available on the PCAOB's Web site.
[15] The white paper prepared by the Assurance Working Group of XBRL International is available on XBRL International's Web site.

## Speech by Louise M. Dorsey, *Associate Chief Accountant*, Division of Corporation Finance of the Securities and Exchange Commission

| Topics Covered | Affects |
|---|---|
| • Item 4.02 Form 8-K issues | All SEC registrants involved in a restatement |
| • Shell company reporting | Shell company registrant that has merged with a private operating company |

### Item 4.02 Form 8-K Issues

Ms. Dorsey offered insights on Form 8-K issues that the SEC staff has addressed within the past year. According to Item 4.02, a Form 8-K is due within four business days after either (1) the registrant determines that its previously issued financial statements can no longer be relied upon because of errors or (2) the independent accountant advises the registrant that the previously issued audit report or completed interim review should no longer be relied upon.

Ms. Dorsey discussed filing the information required by Item 4.02 of Form 8-K in another periodic filing such as a Form 10-K or Form 10-Q, which investors might overlook. She referred to the SEC's Current Report on Form 8-K Frequently Asked Questions, issued on November 23, 2004. Question 1 states, "The registrant may disclose triggering events, other than Items 4.01 and 4.02 events, on the periodic report under Revised Item 5 of Part II of Forms 10-Q and 10-QSB and Item 9B of Form 10-K and Item 8B of Form 10-KSB, as applicable. All Item 4.01 and Item 4.02 events must be reported on Form 8-K."

**Editor's Note:** Ms. Dorsey referred to the General Accounting Office (GAO) report on restatements (the July 24, 2006, report to the ranking minority member of the U.S. Senate's Committee on Banking, Housing, and Urban Affairs). This report observed that many companies did not file a Form 8-K under Item 4.02 (nonreliance on prior financial statements) to notify investors of a restatement of historical financial statements. Some companies simply filed Forms 10-Q or 10-K with this information. The GAO recommended that the SEC clarify its rules so that the Item 4.02 Form 8-K requirement is better understood.

For additional information on the GAO's recommendations, visit the GAO's Web site.

Also, registrant's should consult with their SEC counsel when considering the need to file an Item 4.02 Form 8-K.

An Item 4.02 Form 8-K is not automatically required for every restatement. Before deciding to file an Item 4.02 Form 8-K, the registrant must complete an analysis, based on SAB 99, of the qualitative and quantitative factors associated with the error and conclude that the error is material. If a registrant concludes, on the basis of a SAB 99 analysis, that an error is not material and that an Item 4.02 Form 8-K is therefore not required, the SEC staff may question such a decision if the primary financial statements are restated by filing an amendment to Forms 10-K/10-Q. Ms. Dorsey noted that in such circumstances, a registrant should be prepared to support its decision not to file an Item 4.02 Form 8-K.

She also pointed out that the Item 4.02 Form 8-K must include clear, specific disclosures regarding all relevant information related to the restatement, including a brief description of the facts underlying the conclusion that the financial statements can no longer be relied upon. If the restatement involves the correction of multiple errors, the registrant should include a separate disclosure for each misstatement. If all information is not known at the time of the Form 8-K filing, the registrant should disclose the nature of the unknown information.

In addition, Ms. Dorsey noted that the SEC staff may question the timing of an Item 4.02 Form 8-K if it is filed shortly before an amended Form 10-K or Form 10-Q is filed for the restatement. According to Ms. Dorsey, such contemporaneous filings raise the question of whether the Form 8-K was filed on time, since the trigger for nonreliance occurs when the registrant concludes that the financial statements should no longer be relied upon, not after the investigation or restatement is completed.

Finally, Ms. Dorsey discussed the impact of an Item 4.02 Form 8-K filing on management's report of internal control over financial reporting. Item 4.02 does not require the reassessment of conclusions previously reached by management in its report on internal controls. However, Ms. Dorsey remarked, if any material weaknesses in the internal controls over financial reporting or disclosure controls and procedures are known at the time of the Item 4.02 Form 8-K, management should consider disclosing these weaknesses as well as its duty to restate under Rule 12b-20 of the Securities and Exchange Act of 1934 (the "Exchange Act").

## Shell Company Reporting

Ms. Dorsey also addressed shell company reporting requirements when a shell company performs a reverse merger with a private operating company. A Form 8-K is due within four days after the merger and must include all information required by an initial public offering under the Exchange Act on Form 10/10-SB/20-F. Furthermore, since a shell company reverse merger is considered to be an initial registration under the Exchange Act for the private operating company, its financial statements must be audited on the basis of PCAOB standards. Ms. Dorsey noted that the audit firm issuing the initial PCAOB opinion prior to the consummation of the merger is not required to be a registered public accounting firm. However, pursuant to PCAOB standards, any subsequent opinions must be issued by a registered public accounting firm.

Ms. Dorsey noted that when a Form 8-K is filed shortly after year end or period end, the most recent financial statements may not be included. She stated that the SEC staff believes that to prevent a gap in reporting following the filing of the Form 8-K, Exchange Act Rules 13a-1 and 13a-13, which are designed to prevent a similar gap following the filing of an initial public offering, would apply. The surviving company is required to file the latest year-end or interim financial statements — and other information normally required in a Form 10-K or Form 10-Q — on a Form 8-K/A.

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

| Topics Covered | Affects |
|---|---|
| • Recent SEC staff comments | All SEC registrants |

Mr. Olinger highlighted three disclosures that have generated recurring SEC staff comments: revenue recognition policies, pro forma financial statements and forecasts, and non-GAAP income statements.

First, with respect to revenue recognition policy disclosures, Mr. Olinger noted that the SEC staff continues to issue comments for enhancements in the following areas:

- Disclosure of individual revenue streams.
- Disclosure of multiple element arrangements in a way that an investor can distinguish the deliverables.
- Disclosure of the registrant's ability to estimate rebates, returns, and allowances.
- Disclosure of how and when deferred revenues are recognized in the income statement.
- Consistency between the revenue policy disclosure and the information in the Management's Discussion and Analysis and Business sections of Form 10-K.

Second, Mr. Olinger distinguished between pro forma financial statements and financial forecasts. Article 11 of SEC Regulation S-X requires adjustments for pro forma financial statements to be limited to adjustments that are (1) directly attributable to the transaction, (2) expected to have a continuing impact on the registrant, and (3) factually supportable. He noted that management's plans, such as changes to the revenue streams and cost structure of an entity, do not represent Article 11 pro forma adjustments, but rather are forecasts. He also stated that the SEC staff encourages registrants to provide forecasts and forward-looking information, but emphasized that these disclosures should not be combined with Article 11 pro forma financial statements.

Finally, Mr. Olinger noted that the SEC staff continues to see presentations of full non-GAAP income statements. He indicated that the presentation of a non-GAAP income statement creates multiple non-GAAP measures because many, if not all, line items have been adjusted in a non-GAAP manner. Mr. Olinger also noted that the SEC staff generally objects to the presentation of a full non-GAAP income statement, stating that the staff believes that such a presentation creates the inappropriate impression that the non-GAAP income statement is being presented on a comprehensive basis of accounting, which is not the case. In a later question-and-answer session, Mr. Olinger affirmed that the SEC staff would also object to the presentation of a non-GAAP income statement in quarterly and annual earnings releases furnished on Form 8-K.

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

| Topics Covered | Affects |
| --- | --- |
| • How to stay out of trouble with the Division of Enforcement | Public companies and their auditors |

"Where were the outside accountants?" Mr. Ricciardi believes that independent auditors should want regulators and constituents to continue to ask that question. He acknowledges that there is an expectation gap in that some believe that independent auditors should be able to detect all fraud. However, he wonders what happens to the profession if expectations get too low and no one is asking where the outside accountants were.

Mr. Ricciardi indicated that deterrence is a significant responsibility of the profession and that individuals and entities need to know someone is watching. For deterrence to be effective, he noted that there has to be a high likelihood of detection, that inappropriate actions must be detected quickly, and that the penalty for such actions should be high.

Mr. Ricciardi also discussed his perspective on what auditors should do to stay out of trouble. He listed six points to consider:

- *All communications should reflect your values* — There should be no need to alter or destroy documents if all of your communications reflect your ethical values.
- *Consult* — Provide those with whom you consult all of the facts relevant to the consultation. Consultation may have prevented prevalent errors such as those involving bill and hold, complex derivative, and sale and lease-back transactions. As always, sufficient, competent evidential matter must be obtained to support the facts.
- *Take steps necessary to fix the problem* — When faced with an issue, don't try to make it go away or cover it up. If you don't address it, it will likely turn into an extremely difficult problem.
- *React to the discovery of a potential illegal act* — You should consult with legal counsel to obtain all the facts, but should ensure that counsel does not have conflicting interests with the client. In Mr. Ricciardi's view, you — as auditor — are vouching for the integrity of your client; if there is any doubt, walk away.
- *Recognize your leverage* — As auditor, you have a tremendous amount of leverage. Don't let clients push you around. Firms should support their partners in difficult situations, and audit committees want to hear from you.
- *Partner compensation should be tied to quality*.

Finally, Mr. Ricciardi indicated that there is a perception that competition is limited because there are only four "Big Four" firms. To increase the number of firms capable of performing audits of public registrants, he suggested that it might be in the public interest for the "Big Four" to allow their retiring partners to work at second-tier firms without forfeiting their pension benefits.

## Speeches by:

## Carol A. Stacey, *Chief Accountant*, Division of Corporation Finance of the Securities and Exchange Commission

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

| Topics Covered | Affects |
|---|---|
| • Executive compensation disclosure | All SEC registrants |
| • Restatements resulting from errors in stock option accounting | Companies subject to restatements from errors in stock option accounting |

### Executive Compensation Disclosure

Mr. White discussed the new executive compensation disclosure rule that was adopted by the Commission on July 26, 2006. He noted that the new rule significantly modifies the previous disclosure requirements for executive compensation. It requires a narrative Compensation Discussion & Analysis ("CD&A") section and includes disclosures of the dollar value of equity awards, postemployment payments, and perquisites in a new Summary Compensation Table, which includes a column for total compensation. The new rule is effective for Forms 10-K and 10-KSB for fiscal years ending on or after December 15, 2006.

Mr. White remarked that a key feature of the rule is a principles-based theme and noted that the new CD&A disclosure requirements are "the heart of the changes to the executive compensation disclosure rules." CD&A is similar in concept to the currently required MD&A, albeit covering different subject matter. The CD&A is an example of the importance of a principles-based theme in that it identifies the key objectives of good reporting.

The CD&A and the Summary Compensation Table are covered by Sarbanes-Oxley Section 302 certifications. The new rule requires a revised Compensation Committee Report, which is not covered by the 302 certifications.

Mr. White emphasized that public companies should review their disclosure controls and procedures to ensure the controls are adequate to cover the expanded CD&A disclosures and encouraged financial executives to be actively involved in the development of any new disclosure controls which may be required.

In responding to a question from the audience, Ms. Stacey clarified that perquisites involving no incremental cost to the company should, nevertheless, be included in the executive compensation disclosure. She provided the following example:

**Example**

Assume a named executive officer used the company plane for a business trip. The use of the plane by the named executive officer is not a perquisite because it was used for the business trip. The named executive's spouse travels on the same flight. There is no incremental cost to the company for the spouse's travel; however, the travel is still considered a perquisite.

**Editor's Note:** See Deloitte & Touche LLP's August 21, 2006, *Heads Up* for additional information related to the SEC's disclosure requirements for executive compensation.

### Restatements Resulting From Errors in Stock Option Accounting

Ms. Stacey discussed anticipated guidance for companies filing restated financial statements as a result of errors in accounting for stock options. She referred to the letter that the Office of the Chief Accountant issued on September 19, 2006, discussing the application of stock option accounting guidance. The letter stated that generally, "previously filed reports containing financial statements determined to be materially misstated require amendment."

She remarked that since the option-related problems go back multiple years, many companies have contacted the staff and said they would be “unduly burdened” if they had to restate all prior filings impacted by the errors. Ms. Stacey acknowledged this concern and also indicated that, given the potential number of filings required in the restatement process, investors may have difficulty understanding the restatement as a whole. She discussed the possibility for a “comprehensive” or “catch-up” Form 10-K filing. She indicated that the “comprehensive” or “catch-up” Form 10-K should provide the footnote disclosures required by paragraph 45(c) of Statement 123 as clarified and amended by Statement 148, specifically as it relates to restated net income, stock compensation expense, and pro forma information for the three-year period presented in the Form 10-K. She noted that the anticipated additional disclosures for prior years not included in the filing should include, at least, “year-by-year disclosure of stock compensation expense and any material tax adjustments that were made as a result” of the restatement.

Ms. Stacey indicated that the guidance would most likely be issued “soon” and that it is expected to be issued as a letter to corporation financial executives.

In two cautionary statements, Ms. Stacey indicated first that the guidance and subsequent filings of restated documents do not preclude potential action by the Commission’s Division of Enforcement. Second, she noted that if a company restates under the guidance, it does not prevent the Division of Corporation Finance from requesting a change to restated filings.

## Speech by Sondra L. Stokes, *Associate Chief Accountant*, Division of Corporation Finance of the Securities and Exchange Commission

| Topics Covered | Affects |
|---|---|
| • MD&A of financial condition and results of operations | All SEC registrants |

### MD&A of Financial Condition and Results of Operations

Ms. Stokes emphasized the importance of MD&A, citing the following three objectives:

- To provide sufficient information to allow investors to see the company through the eyes of management.
- To enhance overall financial disclosure and provide the context within which financial information should be analyzed.
- To provide information about the quality and potential variability of earnings and cash flows.

She reminded the audience that MD&A is covered under the definition of disclosure controls and procedures. Accordingly, to determine whether the disclosure controls and procedures are effective, management needs to consider whether the company has appropriate systems and procedures in place to prepare comprehensive MD&A.

Ms. Stokes believes that MD&A has become more reader friendly and informative since the SEC's last interpretive release in December 2003. Nevertheless, she noted the need for additional improvements in the following three areas:

#### Disclosure Explaining the Reasons for Changes in the Results of Operations

Ms. Stokes stated that MD&A is an opportunity for management to tell the "story behind the numbers." Disclosure should provide a background on the financial statements and a clear picture of the company's operations and transactions. MD&A should go beyond information already included in the financial statements and footnotes and explain why the numbers changed. Specific analysis of the reasons for changes in the results of operations, and not merely stating the amount of dollar and percentage changes, will dramatically improve the quality of disclosure.

#### Critical Accounting Estimates

According to Ms. Stokes, the critical accounting estimates discussion is particularly important when the estimates or assumptions are potentially volatile. She believes that this discussion should not be identical to the accounting policies disclosure in the footnotes to the financial statements; rather, it should present an analysis of significant assumptions or uncertainties involved in applying accounting principles at a given time or the variability that is reasonably likely to result in their application over time. She noted that in presenting such an analysis, management should consider the following items:

- How the estimates are determined.
- How accurate the estimate or assumption has been in the past.
- How much the estimate or assumption has changed in the past.
- What drivers are affecting variability.
- What estimates or assumptions are reasonably likely to change in the future.

She also noted that because critical accounting estimates and assumptions are based on matters that are highly judgmental, the company should discuss the sensitivity of the estimate. The critical accounting estimates discussion should only focus on the estimates that are truly critical. Ms. Stokes provided some examples of critical accounting estimates, such as valuation of assets, goodwill and other intangibles, pension and other postemployment benefits, liabilities and reserves, derivatives and financial instruments, revenue recognition, and income taxes. The critical accounting estimates discussion should be specific to each company.

### Liquidity and Capital Resources

Ms. Stokes indicated that a discussion about liquidity and capital resources should identify trends or any known demands, commitments, events, or uncertainties that are reasonably likely to have material effects on an entity's liquidity. Furthermore, the discussion should provide sufficient information for investors to determine the likelihood that the historical sources of cash are indicative of an entity's ability to meet its future cash requirements. In assessing the trends, management must evaluate all relevant information available, even when the information itself is not required to be disclosed. Ms. Stokes also emphasized that the discussion should focus on the key drivers and the underlying causes of changes in cash flows. It should not be a recitation of the quantitative changes presented in the statement of cash flows.

She remarked that the liquidity and capital resources discussion should also address the company's borrowing. If financing arrangements have been material to an entity's historical cash flows, qualitative information about an entity's financing arrangements (e.g., potential change in credit rating) may be needed. Liquidity disclosure should present a candid picture of the demands on an entity's cash and the sources to meet those demands.

Ms. Stokes observed that disclosure of off-balance-sheet arrangements needs improvement and should include all necessary information about the arrangements and their material impacts. During the 2004 SEC Conference, Ms. Rachel Mincin, associate chief accountant, Division of Corporation Finance of the Securities and Exchange Commission, described best practices for disclosures of off-balance-sheet arrangements. A summary of Ms. Mincin's speech can be found in Deloitte & Touche LLP's December 23, 2005, *Heads Up*.

During the question-and-answer session, Ms. Stokes indicated that expected payments related to interest, pension funding, taxes, insurance, and litigation should either be included in the contractual obligations table or as a narrative disclosure in a footnote to the table. If, owing to variable interest rates or interest rate hedging arrangements, interest payments are difficult to calculate and are therefore not included in the table, narrative disclosure should be included as a footnote to the contractual obligations table.

**Editor's Note:** The SEC's interpretive guidance released in December 2003 is available on the SEC's Web site.

# INTERNAL CONTROL OVER FINANCIAL REPORTING AND OTHER AUDITING MATTERS


**Speeches by:**

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

**Phil Peters, *Deputy Director of International Inspections Division of Registration and Inspections*, Public Company Accounting Oversight Board**

**Phil Wedemeyer, *Director of Office of Research and Analysis*, Public Company Accounting Oversight Board**


| Topics Covered | Affects |
|---|---|
| • PCAOB inspections | All SEC registrants and registered public accounting firms |
| • PCAOB international inspections | Registered public accounting firms |
| • PCAOB's Office of Research and Analysis | |

## PCAOB Inspections

Mr. Diacont reminded participants that the inspection jurisdiction of the PCAOB covers registered public accounting firms ("firms" or "accounting firms") and associated person(s) of such firms and that the PCAOB is not required to notify issuers of an inspection or the results of its findings. He noted that there are no prohibitions, legal or otherwise, on an auditor discussing the inspection process and results with the issuer. He further stated that although inspections are of accounting firms, inspections can result in restatements of financial statements and in some cases referral of matters to the SEC (e.g., improper accounting or SEC reporting, the identification of fraud, or independence violations).

Mr. Diacont also discussed typical inspection findings the PCAOB is seeing in both small and large firms and noted that many of the findings fall into the following broad categories:

- Failure to test or inadequate substantive testing (e.g., related to business combinations, joint ventures, debt agreements, etc.).
- Inadequate disclosures related to business combinations.
- Inappropriate participation in the preparation of significant portions of the financial statements.
- Insufficient procedures around service auditors' reports.
- Inappropriate use of accounts receivable confirmations.
- Inappropriate reliance on system-generated reports.

Mr. Diacont stated that inspections of audits of internal control over financial reporting ("ICFR") in 2006 focused on how efficiently firms achieved the objectives of an ICFR audit. He indicated that a primary focus is reducing the costs of auditing ICFR and that the PCAOB expects to continue its efficiency efforts in 2007 and possibly beyond. He remarked that strengthening the quality control of accounting firms and making improvements in their consultation processes were among the many benefits realized since the PCAOB began inspections in 2003. He also indicated that the top priority of Chairman Mark W. Olson is to issue inspection reports on a timely basis.

## PCAOB International Inspections

Mr. Peters pointed out that there are currently 1,500 foreign private issuers and that 744 firms in 82 countries have registered with the PCAOB. He stated that the PCAOB uses the U.S. market capitalization as the measure in setting the priority for inspections. He noted that many foreign countries already have some auditing oversight organizations and that others are working to create them. Mr. Peters also remarked that the PCAOB is working with the local oversight organizations to facilitate the foreign inspection process and that it plans to significantly increase international inspections for 2007.

## PCAOB's Office of Research and Analysis

Mr. Wedemeyer indicated that the goal of the PCAOB's Office of Research and Analysis is to identify financial statement accounts with an associated risk of a material error. He noted that the PCAOB performs an analysis of risk factors associated with issuers and firms serving as auditors of public companies as part of planning its inspections. He stated that some risk factors that are specific to issuers include prior restatements, lawsuits, prior audit failures, press coverage, comparisons to industry norms, and significant changes in the organizations, such as major acquisitions and changes in management. With respect to independent auditors, Mr. Wedemeyer indicated that the PCAOB considers partner compensation, past inspection results, and the firm's internal inspection results in its identification of risks.

**Editor's Note:** See speech by PCAOB Chairman Mark W. Olson on his remarks before the Exchequer Club in Washington, D.C., on December 13, 2006, in which Mr. Olson shares his perspectives on prudential supervision and how the PCAOB is applying this approach.

## Speech by Michael Gaynor, *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 | All SEC registrants and auditors of public companies |

Mr. Gaynor explained that although the number of companies reporting material weaknesses has decreased from year one to year two, the types of material weaknesses reported typically are associated with causes of restatements and audit adjustments, such as revenue recognition, income taxes, significant liabilities and estimates, and valuation reserve accounts. Thus, the disclosures indicate that the control deficiencies are not discovered through management's evaluation process but through the identification of an audit adjustment or a restatement.

According to Mr. Gaynor, the disclosures also indicate that appropriately designed controls were not in place in areas involving accounting estimates and complex accounting issues. He suggested that companies should apply appropriate diligence in their internal control evaluations and should perform a careful analysis to determine whether the design and operation of controls are adequate to prevent or detect material misstatements in areas of high risk.

Because many material misstatements are associated with estimates, Mr. Gaynor suggested that SAS 57 and SAS 101 may be helpful, since they describe the types of controls that may reduce the risk of material misstatement related to estimates.

Mr. Gaynor voiced concern over the lack of reporting of material weaknesses involving controls for addressing fraud risks. He encouraged management to conduct a robust fraud risk assessment and to implement such controls.

He encouraged management to refer to available guidance in performing risk assessments, including the assessment of fraud risk. Specifically, he referred to (1) the recently published guidance of the Committee of Sponsoring Organizations of the Treadway Commission for smaller public companies and (2) *Management Override of Internal Control: the Achilles' Heel of Fraud Prevention*, available on the AICPA's Web site. Mr. Gaynor also noted that the SEC would soon be proposing guidance on management's evaluation of internal control (see "Editor's Note" regarding Commission's open meeting on December 13, 2006, in the summary of Zoe-Vonna Palmrose's speech).

## Speech by Michael W. Husich, *Associate Chief Accountant*, Office of the Chief Accountant of the Securities and Exchange Commission

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

### Smaller Audit Firms and Smaller Companies

Mr. Husich commented that the staff often receives inquiries from smaller companies and smaller audit firms about assisting clients with implementation of, or ongoing compliance with, recently issued accounting standards. As Mr. Husich pointed out, the SEC's May 2005 statement on implementation of Section 404 of the Sarbanes-Oxley Act of 2002 encourages frequent and frank dialogue between management, auditors, and audit committees. Therefore, he concluded that management should not be dissuaded from seeking the auditor's guidance about complex matters as long as management determines what accounting to use and makes its own judgments.

The dilemma facing issuers and their auditors is to ascertain the point at which advice from the accountant ends and managerial responsibility begins. The following are a few questions for registrants and auditors to consider in determining whether the auditor is performing a managerial function that may impair his or her independence:

- Does management have sufficient knowledge to maintain materially accurate books and records without de facto delegation of the financial reporting process to the auditor?
- Is the auditor providing the audit client with technical guidance, research materials, advice, comments, or editorial suggestions regarding presentation of the footnotes or basic financial statements as opposed to making significant adjustments to the financials or rewriting the footnotes?
- Is management's financial expertise commensurate with the complexity of both the business and the relevant accounting standards?
- Is management taking full responsibility for the judgments applied in preparing the financial statements, or has undue reliance been placed on the auditor's judgment?
- Would a reasonable investor be concerned about the number and significance of adjustments proposed by the auditor?

### Independence Guidance

The SEC staff is considering additional guidance concerning the application of the auditor independence rules, including the following:

- **Interpretation of the "not subject to audit" provision.**[16] The staff's position is that a successor auditor's independence would not be impaired if the successor auditor provides prohibited non-audit services in the current audit period and if these services (1) relate solely to the prior period audited by a predecessor auditor, (2) will not be subject to audit procedures by the successor auditor, and (3) are not management functions.
- **Auditor of employee benefit plan (Form 11-K filer).** The staff's position is that the independence of the auditor of the Form 11-K filer would not be impaired if the auditor provides certain non-audit services to the sponsor, as long as (1) the services are within the scope of the "not subject to audit" provision and (2) the auditor does not provide any service that would effect the benefit plan audit.
- **Interpretation 46(R).** The staff's position is that the auditor should be independent of all entities required to be consolidated by a registrant under Interpretation 46(R), even when a variable interest entity is not consolidated due to materiality or other considerations.

### Independence Discussions With Audit Committees

Mr. Husich commented that independence discussions with audit committees should touch on matters that, from a reasonable investor's perspective, bear on the auditor's independence.

[16] See Rule 2-01(c)(4)(i)–(v) of Regulation S-X

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

| Topics Covered | Affects |
|---|---|
| • Improving audit effectiveness | All SEC registrants and auditors of public companies |

Ms. Palmrose focused on the importance of improving audit effectiveness. She expressed her view that audit effectiveness is a partnership between regulators, audit firms, and clients, including management and audit committees. She also remarked that audit effectiveness is a function of both standards and performance. In her view, standards — whether auditing, quality control, or independence — provide a floor for auditor performance and audit firms should have incentives to go beyond this and compete on the basis of quality.

Ms. Palmrose acknowledged that improving audit effectiveness poses a number of public policy challenges. Some of those challenges involve (1) appropriately calibrating standards and performance in audits of ICFR to restore the value proposition and (2) effectively integrating the ICFR and financial statement audits. To address this, the PCAOB has been working with the SEC to revise PCAOB Auditing Standard 2[17] and the SEC is considering providing management with guidance on planning and conducting its evaluation of ICFR under Section 404(a) of the Sarbanes-Oxley Act of 2002.

**Editor's Note:** The SEC held an open meeting on December 13, 2006, at which it proposed interpretive guidance regarding management's assessment of ICFR. More information about the open meeting and proposed management guidance is available on SEC's Web site.

Ms. Palmrose stated that rationalizing Section 404 is an enormously important challenge that must be met for integrated audits to be effective. She warned that inspections focusing on audit efficiency rather than audit effectiveness, and excessive pressure on audit fees from audit committees, may actually undermine audit effectiveness. She concluded by stating that audit effectiveness is created through a partnership and that, by focusing on the goal, it can be achieved.

[17] On December 19, 2006, the PCAOB issued for public comment a proposed new standard on auditing internal control over financial reporting that would replace Auditing Standard 2. The PCAOB also issued other related proposals.

## Panel Discussion on International Accounting Standards:

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

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

## Janet L. Pegg, *Senior Managing Director*, Bear Stearns & Co. Inc.

| Topics Covered | Affects |
|---|---|
| • IASB agenda | All preparers, auditors and users of IFRS financial statements |
| • Application of IFRS in practice | Foreign private issuers who prepare financial statements under IFRS |
| • IFRS from the investor's perspective | All preparers, auditors and users of IFRS financial statements. The remarks summarized in this section expressed views on broad issues facing the financial reporting community |

The presenters discussed issues related to IFRS, including issues arising from the first-time application of IFRS, as well as insight into investors' perspectives of the transition to IFRS across the world.

### IASB Agenda

Mr. Crooch provided an update on activities at the IASB. He reiterated the objective of the IASB and FASB to converge on a single set of high-quality accounting standards. He summarized short-term and long-term convergence projects as well as the projects on the IASB's research agenda.

**Editor's Note:** Information about the IASB's agenda can be found on Deloitte's IAS Plus Web site.

### Application of IFRS in Practice

Based on comment letters sent to approximately 50 foreign private issuers who filed their primary financial statements under IFRS with the SEC, Ms. Ehrhardt discussed the SEC staff's initial impressions on the application of IFRS standards.

The staff's comments fall in two general categories: presentation and disclosure. With respect to overall presentation, she encouraged registrants to review the layout and organization of the financial statements and footnotes and consider making improvements to provide more transparent and understandable information for the investor. She also described the following deficiencies:

- Financial statement information required by IFRS is incorrectly presented outside the financial statements.
- Multiple forms of "operating income" are used in the income statement.
- In the reconciliation of cash flows under the indirect method, diversity exists in the starting point of cash flows from operating activities.

On the subject of disclosure, comments have covered a wide range of topics that generally fall into three categories:

- Omitted disclosures — Examples include the number of authorized shares, events and circumstances that led to the recognition of an impairment loss, and reasons explaining how the filer overcame a presumption on the use of consolidation or application of the equity method.

- Confusing disclosures — Required information was not clearly explained or was scattered throughout the filing. Ms. Erhardt encouraged registrants to reconsider the organization of such disclosures in an effort to improve the overall understandability of the financial statements.
- "Shallow" disclosures — Situations in which the information is present, but doesn't tell the investor anything of substance. She cited disclosure of revenue recognition policies, copied directly from IAS 18, that fail to explain the various streams of revenue or the revenue recognition policy for each individual stream.

Ms. Erhardt acknowledged that her comments did not pertain to application of accounting standards. Given the early stages of its reviews, the SEC staff is not yet in a position to offer specific comments on the application of accounting standards.

## IFRS From the Investor's Perspective

Ms. Pegg provided her insight into the investor's perspective of the initial adoption of IFRS around the world. She highlighted some of the concerns investors have with IFRS, in particular the potential for inconsistent application of IFRS across countries and the resulting lack of financial statement comparability. Other concerns include a general lack of knowledge about IFRS in the marketplace and the fact that IFRS sometimes allows entities to choose from alternative accounting policies. Due to the recent emergence of IFRS, investors are experiencing difficulties performing long-term historical analysis.

Ms. Pegg also expressed concern about the potential elimination of the reconciliation from IFRS to U.S. GAAP by 2009. She indicated that there may not be sufficient time to deal with issues that arise out of the initial adoption and application of IFRS, and noted that some feel that it may take as long as five to ten years for IFRS to be more consistently applied. Some investors believe that there is significant value to the information that is contained in the U.S. GAAP reconciliation.

Despite these concerns, Ms. Pegg did indicate that U.S. investors are becoming more familiar with IFRS. She also noted that investors like the idea of a single set of high-quality global standards and believe that eventually it will improve their ability to analyze and compare companies around the world.

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

| Topics Covered | Affects |
|---|---|
| • Internal controls over financial reporting under Section 404 of the Sarbanes-Oxley Act<br>• Exchange act deregistration by foreign private issuers<br>• IFRS implementation<br>  • Review process<br>  • Frequent staff comments<br>• U.S. GAAP reconciliations<br>• Reporting issues<br>  • SAB 108<br>  • Parent–only schedules under Regulation S-X<br>  • Mandatory minimum dividends<br>  • Foreign GAAS | Foreign private issuers who prepare financial statements under IFRS and their auditors |

### Internal Controls Over Financial Reporting Under Section 404 of the Sarbanes-Oxley Act

Mr. Olinger provided an overview of the following recently issued or proposed rules, as well as certain clarifications related to 404 matters specific to foreign private issuers (FPIs) that will affect reporting by FPIs.

### Exchange Act Deregistration by Foreign Private Issuers

Mr. Olinger noted that on December 13, 2006, the SEC voted to repropose certain amendments to the rules allowing foreign private issuer deregistration under the Exchange Act. For further information, see the December 13, 2006, SEC Press Release No. 2006–207.

| New Or Proposed Rule | Management's Report | Auditor's Attestation |
|---|---|---|
| Final rule on internal control over financial reporting in exchange act periodic reports of FPIs that are accelerated filers | Fiscal years ending on or after July 15, 2006 | Fiscal years ending on or after July 15, 2007 |
| The rule does not change the current requirements for compliance with Section 404 for large accelerated FPIs | Fiscal years ending on or after July 15, 2006 | Fiscal years ending on or after July 15, 2006 |
| Proposed relief from Section 404 compliance dates for non-accelerated filers (including FPIs) | Fiscal years ending on or after December 15, 2007 | Fiscal years ending on or after December 15, 2008 |
| Proposed transition relief for newly public companies (including FPIs) | Not required until the newly public company files its second annual report with the SEC | Not required to provide until it files its second annual report with the SEC |

| Clarifications Related to 404 Matters | Management's Report | Auditor's Attestation |
|---|---|---|
| Debt-Only Foreign Private Issuers With Publicly Traded Equity in a Jurisdiction Outside the United States | | |
| • A foreign private issuer with only registered debt in the United States, but publicly traded equity in a jurisdiction outside the United States, would not be considered an accelerated filer for purposes of determining the compliance date for internal control reporting under Section 404. | Fiscal years ending on or after December 15, 2007 | Fiscal years ending on or after December 15, 2008 |
| Consideration of Proportionately Consolidated Entities in Management's Assessment of Internal Controls | Certain foreign country GAAP (including IFRS) either allow or require proportionate consolidation. Mr. Olinger clarified that proportionately consolidated entities should be included in management's assessment of internal controls over financial reporting. However, he acknowledged that there may be instances in which management cannot assess the internal controls. In such cases, management's report on internal control over financial reporting should provide disclosure regarding such entities. | Same as for Management's Report |

## IFRS Implementation

Mr. Olinger provided an update on the SEC staff's reviews of filings in which IFRS was used for the first time, including frequent staff comments.

### Review Process

He noted that the Division of Corporation Finance follows the same review process for foreign private issuers and domestic registrants. In accordance with the Sarbanes-Oxley Act, all registrants, including foreign private issuers, are reviewed at least once every three years. A registrant may be the subject of either a full review or a "targeted" review that only addresses a specified area of the filing. All reviews are conducted by a staff accountant and reviewed by a supervisory accountant. He also indicated that the SEC comment letters and the related responses will be posted to EDGAR no less than 45 days after the conclusion of the review.

Mr. Olinger discussed the implementation of the SEC–CESR (Committee of European Securities Regulators) work plan (see SEC Press Release 2006–130) and noted that the SEC staff will consult with the applicable home-country regulator regarding the application of IFRS in the following situations:

- A registrant submits a preclearance request to the Office of the Chief Accountant of the SEC on the application of IFRS.
- A "novel and unprecedented" IFRS issue is identified.
- The SEC staff is advised by a registrant that a home-country regulator has a differing view on an IFRS issue that has been raised by the SEC staff.

- A significant change to the financial statements would result from an issue raised by the SEC staff.

Under the work plan, the same process would work in reverse regarding overseas filings under U.S. GAAP.

**Frequent Comments**

Mr. Olinger discussed certain topics that have given rise to frequent SEC staff commentary. These areas also were noted at a higher level by Julie Erhardt, deputy chief accountant, Office of the Chief Accountant of the SEC and include the following:

- Assertion of compliance with IFRSs as published by the IASB.

Mr Olinger remarked that the accommodation provided in Instruction G of Form 20-F regarding the omission of certain required financial statements requires that the registrant assert, by an explicit and unreserved statement, that the financial statements are prepared in compliance with IFRSs as published by the IASB. The instruction does provide exceptions for certain European issuers, who are complying with IFRSs as adopted by the European Union. The SEC staff has issued comments in situations in which a registrant has only asserted compliance with a jurisdictional adaptation of IFRSs. Jurisdictional IFRSs refers to IFRSs that have been modified by a local jurisdiction and that are therefore no longer equivalent to IFRS as published by the IASB.

- Income statement presentation.

Mr. Olinger indicated that the SEC staff has noted diversity in income statement presentation formats, noting instances in which the registrant presented multiple "operating" subtotals. These line items may confuse investors; often it is unclear why certain items are excluded from one "operating" subtotal but not another. He also noted that the staff has questioned how these items comply with paragraph BC 13 of IAS 1, which states, in part, "…it would be misleading and would impair the comparability of financial statements if items of an operating nature were excluded from the results of operating activities, even if that had been industry practice." The staff also has commented on the lack of disclosure explaining the relevance of such items.

- Cash flow statement presentation.

Mr. Olinger noted that the most frequent SEC comment on cash flow statement presentation relates to the starting point for reconciliation from "profit or loss" to "cash flow from operating activities" (when the indirect method is used). He stated that while profit or loss is not defined in IAS 7, it is defined elsewhere in IFRS, specifically in IAS 1. Accordingly, the SEC staff has been commenting when the starting point for the reconciliation is some other metric.

Mr. Olinger referred to an SEC accommodation that exempts from the U.S. GAAP reconciliation requirement cash flow statements that are prepared in accordance with IAS 7. The varying cash flow statement presentations seen in filings to date may cause the SEC staff to question whether a cash flow statement prepared under IAS 7 would be "substantially similar" as contemplated by the SEC when it developed the accommodation. He noted that the underlying basis for the accommodation was that the SEC staff's belief that a cash flow statement prepared in accordance with IAS 7 would be "substantially similar" to a cash flow statement prepared under U.S. GAAP (Statement 95).

- Investments in subsidiaries and associates.

The SEC staff has commented on the omission of certain required disclosures related to the accounting for investments in subsidiaries and associates. Mr. Olinger pointed out that registrants failed to disclose the reasons why a presumption was overcome that a particular accounting method (i.e., consolidation or equity accounting) be used.

- Revenue recognition.

The SEC staff has commented on the absence of robust disclosure relating to revenue recognition policies. Mr. Olinger noted that the SEC staff believes that the revenue recognition policies should address the various revenues streams that are usually outlined in the Business section and the accounting model the registrant applies to each stream.

- Asset impairments.

Mr. Olinger remarked that there are two primary issues related to asset impairments: (1) required disclosure of the main events and circumstances that led to the recognition of an impairment loss was omitted, and (2) required disclosure of the estimates used to measure the recoverable amounts of cash-generating units containing goodwill was omitted.

## U.S. GAAP Reconciliations

Mr. Olinger noted that the U.S. GAAP reconciliation should include a narrative discussion and quantification of material variations in accounting principles, practices, and methods used in preparing the financial statements between home-country GAAP (including IFRS) and U.S. GAAP. He indicated that when an adjustment affects several balance sheet line items, disclosure of the impact on each caption is required. Similarly, when multiple adjustments affect a single line item, the staff expects there to be disclosure of the adjustment on a disaggregated basis to enable an investor to understand the impact of each individual adjustment. The U.S. GAAP reconciliation should be in sufficient detail to allow an investor to re-create U.S. GAAP financial statements.

## Reporting Issues

### Staff Accounting Bulletin 108

Mr. Olinger stated that SAB 108 applies to information in the U.S. GAAP reconciliation in the same manner as it would to a U.S. domestic entity's U.S. GAAP financial statements. While SAB 108 does not explicitly apply to the primary financial statements of a foreign private issuer, the staff believes that the concept of materiality should not result in differences between home-country GAAP (including IFRS) and U.S. GAAP. Therefore, it is expected that SAB 108 normally will be applied to the primary home-country GAAP financial statements. Mr. Olinger encouraged discussion with the SEC staff if a FPI contemplates presenting a reconciling difference for errors not corrected in the primary home-country GAAP financial statements but corrected in the U.S. GAAP reconciliation.

He also noted that the cumulative-effect method of initially applying the guidance in SAB 108 generally would be inconsistent with the accounting standards in most countries (including IFRS). When retrospective application is required by home-country GAAP, the SEC staff will not object to companies' presenting the initial application of SAB 108 by retroactively restating prior-period U.S. GAAP information instead of electing the cumulative-effect option in SAB 108. Regardless of the method used, the SEC staff would still expect companies to disclose the nature and amount of each individual item that is being adjusted.

### Parent-Only Schedule Under SEC Regulation S-X, Rule 5-04

Mr. Olinger pointed out that SEC Regulation S-X, Rule 5-04, requires that condensed parent-only financial information be presented when restricted net assets of consolidated subsidiaries exceed 25 percent of consolidated net assets as of the end of the most recent completed fiscal year. This requirement means that the parent-only financial statements must be prepared on the same GAAP basis as the primary financial statements. Mr. Olinger indicated that there may be instances in which, for statutory purposes, the entity is required to provide parent-only financial statements prepared on a basis of GAAP different than that used in the primary consolidated financial statements. He stated that SEC staff would not object to this approach, provided that net income and shareholders' equity are reconciled to the GAAP that is used in preparing the registrant's primary financial statements.

Mr. Olinger reiterated that the parent company should account for its investment in subsidiaries by using the equity method when preparing parent-only financial information. Home-Country forms of GAAP (including IFRS) may require or permit the investment in subsidiaries to be carried at cost. The SEC staff would not object to this difference if net income and shareholders' equity on a cost basis are reconciled to an equity method basis.

Finally, Mr. Olinger noted that there may be circumstances in which the parent-only financial information would not be required by the SEC's rules but would be required by the registrant's local statutory rules. The staff would not object to the inclusion of parent-only financial information in the Form 20-F, provided that the nature, purpose, and limitations of such presentation are clearly disclosed.

### Mandatory Minimum Dividends

Mr. Olinger discussed the accounting for mandatory minimum dividends under U.S. GAAP. He noted that Chilean companies are required by law to distribute 30 percent of their net income to shareholders (a majority of shareholders can approve the nonpayment of the dividend). The SEC staff has required Chilean registrants to identify as temporary equity, in the reconciliation to U.S. GAAP, the amount of retained earnings applicable to the dividend to be distributed. The SEC staff is now aware that there are similar laws in other countries. Mr. Olinger emphasized that the guidance for presentation of mandatory minimum dividends in Chile applies to other jurisdictions with a similar requirement. He also noted the compelling argument that mandatory minimum dividends should be classified as a liability, as they represent an obligation to pay. Accordingly, he noted that the staff believes liability classification is preferable to presentation as temporary equity.

**Foreign GAAS**

Mr. Olinger noted that the financial statements of issuers included in SEC filings must be audited under PCAOB standards. Financial statements of non-issuers included in SEC filings (i.e., financial statements of private companies required under Regulation S-X, Rule 3-05 or Rule 3-09) may be audited under either PCAOB standards or U.S. GAAS, but use of foreign GAAS would not be accepted.

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

| Topics Covered | Affects |
|---|---|
| • IOSCO IFRS Database Arrangement | Foreign private issuers who prepare financial statements under IFRS |

Ms. Luallen summarized the International Organization of Securities Commissions (IOSCO) IFRS database arrangement. IOSCO has an initiative under way to promote consistent interpretation and application of IFRSs across the globe. It involves the creation of a database to which regulators will contribute information about regulatory decisions relating to the interpretation and application of IFRS.

To participate, regulators must sign participation agreements and are expected to use their best efforts to refer to this database when making decisions and to contribute information. Contribution of information is not required but is encouraged. Conflicting decisions on the application of IFRS will be referred to the IASB and its interpretation committee. All information contributed to the IOSCO database will be confidential, and the database will not be publicly accessible. Ms. Luallen anticipates SEC participation in the database arrangement.

# Appendix A: Glossary of Standards

FASB Statement No. 5, *Accounting for Contingencies*

FASB Statement No. 57, *Related Party Disclosures*

FASB Statement No. 87, *Employers' Accounting for Pensions*

FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*

FASB Statement No. 95, *Statement of Cash Flows*

FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*

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

FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits*

FASB Statement No. 123, *Accounting for Stock-Based Compensation*

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

FASB Statement No. 128, *Earnings per Share*

FASB Statement No. 131, *Disclosures About Segments of an Enterprise and Related Information*

FASB Statement No. 132(R), *Employers' Disclosures About Pensions and Other Postretirement Benefits*

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

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

FASB Statement No. 141, *Business Combinations*

FASB Statement No. 148, *Accounting for Stock-Based Compensation — Transition and Disclosures*

FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*

FASB Statement No. 157, *Fair Value Measurements*

FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*

FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*

FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation*

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

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

FASB Staff Position (FSP) No. FAS 115-1 and FAS 124-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments"

Proposed FASB Staff Position (FSP) No. EITF 00-19-b, "Accounting for Registration Payment Arrangements"

Proposed FASB Staff Position (FSP) No. EITF 03-6-a, "Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities"

FASB Technical Bulletin No. 85-5, *Issues Relating to Accounting for Business Combinations*

Statement 133 Implementation Issue No. B15, "Embedded Derivatives: Separate Accounting for Multiple Derivative Features Embedded in a Single Hybrid Instrument"

Statement 133 Implementation Issue No. E6, "Cash Flow Hedges: The Shortcut Method and the Provisions That Permit the Debtor or Creditor to Require Prepayment"

Statement 133 Implementation Issue No. G7 "Cash Flow Hedges: Measuring the Ineffectiveness of a Cash Flow Hedge Under Paragraph 30(b) When the Shortcut Method Is Not Applied"

FASB Staff Implementation Guide (Statement 87), "A Guide to Implementation of Statement 87 on Employers' Accounting for Pensions"

FASB Staff Implementation Guide (Statement 88), "A Guide to Implementation of Statement 88 on Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits"

FASB Staff Implementation Guide (Statement 106), "A Guide to Implementation of Statement 106 on Employers' Accounting for Postretirement Benefits Other Than Pensions"

EITF Issue No. 88-18, "Sales of Future Revenues"

EITF Issue No. 99-12, "Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination"

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

EITF Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities"

EITF Issue No. 02-5, "Definition of 'Common Control' in Relation to FASB Statement No. 141"

EITF Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments"

EITF Issue No. 03-6, "Participating Securities and the Two-Class Method Under FASB Statement No. 128"

EITF Issue No. 04-5, "Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights"

EITF Issue No. 05-4, "The Effect of Liquidated Damages Clause on a Freestanding Financial Instrument Subject to Issue No. 00-19, 'Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock'"

EITF Issue No. 06-12, "Accounting for Physical Commodity Inventories for Entities within the Scope of the AICPA Audit and Accounting Guide, *Brokers and Dealers in Securities*"

EITF Topic No. D-97, "Push-Down Accounting"

EITF Topic No. D-98, "Classification and Measurement of Redeemable Securities"

APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*

APB Opinion No. 21, *Interest on Receivables and Payables*

APB Opinion No. 25, *Accounting for Stock Issued to Employees*

Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*

Accounting Research Bulletin No. 43, Chapter 4, "Inventory Pricing"

AICPA Statement on Auditing Standards No. 57 (AU Section 342), *Auditing Accounting Estimates*

AICPA Statement on Auditing Standards No. 99 (AU Section 316), *Consideration of Fraud in a Financial Statement Audit*

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

AICPA Professional Standards, Attestation Standards Section 101, "Attest Engagements"

AICPA Technical Practice Aids, TIS Section 5100.42, "Extended Payment Terms and Software Revenue Recognition"

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

SEC Regulation S-X, Rule 2-01, "Qualifications of Accountants"

SEC Regulation S-X, Rule 3-01, "Consolidated Balance Sheets"

SEC Regulation S-X, Rule 3-02, "Consolidated Statements of Income and Changes in Financial Position"

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

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 5-04, "What Schedules Are to Be Filed"

SEC Regulation S-K, Item 101, "Description of Business"

SEC Regulation S-K, Item 301, "Selected Financial Data"

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

SEC Staff Accounting Bulletins No. 54 and 73 codified as SAB Topic 5.J, "Push Down Basis of Accounting Required in Certain Limited Circumstances"

SEC Staff Accounting Bulletin No. 74, codified as SAB Topic 11.M, "Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period"

SEC Staff Accounting Bulletin No. 80, codified as SAB Topic 1.J, "Application of Rule 3-05 in Initial Public Offerings"

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

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

SEC Staff Accounting Bulletin No. 108, codified as SAB Topic 1.N, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements"

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

Item 4.01, "Changes in Registrant's Certifying Accountant"

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

SEC Form 10-K, Item 9 — Changes in and Disagreements With Accountants on Accounting and Financial Disclosure

Item 9B, "Other Information"

SEC Form 10-KSB, Item 8 — Changes in and Disagreements With Accountants on Accounting and Financial Disclosure

Item 8B, "Other Information"

SEC Form 10-Q, Item 5 — Other Information

SEC Form10-QSB, Item 5 — Other Information

SEC Exchange Act Rules — Reports of Issuers

Rule 12b-20, "Additional Information"

Rule 13a-1, "Requirements of Annual Reports"

Rule 13a-13, "Quarterly Reports on Form 10-Q and Form 10-QSB"

SEC Financial Reporting Release No. 72, *Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations*

PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements*

IAS 1, *Presentation of Financial Statements*

IAS 7, *Cash Flow Statements*

IAS 14, *Segment Reporting*

# Appendix B: Topical Index

**SEC MATTERS**



**SHARE-BASED PAYMENT/BACKDATING**



**STATEMENT OF CASH FLOWS**



**TAXES**



**TRANSPARENCY/COMPLEXITY**



**XBRL**

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