

SEC and Accounting Hot Topics

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Presenter: Stephen Sommerville,
PricewaterhouseCoopers LLP

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Agenda

- SEC Hot Topics
- Income Taxes
- Internal Controls Update
- Panel Discussion
- Questions

SEC Hot Topics

- Recent Comments
- Cash flows
- Registration Rights
- Preferred stock warrants
- Hedge Accounting
- SAB 108
- Stock Based Compensation

Recent SEC Comment - Segments

- “We note that you present one reportable segment. We further note your segment revenue presentation for your various services. Tell us how you determined your segments under FAS 131. Your response should address how you evaluated paragraphs 10-15 when identifying your operating segments and 16-24 when identifying your reportable segments.”

Recent SEC Comment - Impairments

- “There is a concern that investors may have been surprised by the ... impairment charge. In this regard, we note the significant impact on share price when the charge was announced... Item 303 of Regulation S-K requires MD&A disclosure of material uncertainties unless management has concluded that the uncertainty is not reasonably likely to materially impact future operating results...”

Recent SEC Comment – Impairments

- “...Section 216 of the Financial Reporting Codification states that ‘registrants have an obligation to forewarn investors of deteriorating conditions which, unless reversed, may result in a subsequent write-off. This includes an obligation to provide information regarding the magnitude of exposure to loss.’ ... Please clarify for us why there was apparently no specific, prior disclosure regarding a material uncertainty over the recoverability of the goodwill.”

Recent SEC Comment – Contingencies

- “Revise your interim disclosures in future filings to include disclosure about all material contingencies, even if no changes have occurred since fiscal year-end.”

Recent SEC Comment – Contingencies

- “Please expand your disclosures to clarify your policy regarding litigation and contingencies that are reasonably possible. Please explain how you determine whether or not to disclose a particular matter or matters which may be significant individually or in the aggregate.”

Recent SEC Comment – EPS

- “Please advise or revise your future filings to explain the relevant rights and privileges of common stock and Class B common stock, specifically highlighting the substantive differences between each series of common shares.”

Recent SEC Comment – EPS

- “We would expect basic and diluted earnings per share to be calculated using the two-class method in accordance with Issue 3 of EITF 03-06. Please tell us if you view the two-class method to be applicable, or why you believe your current presentation is more appropriate.”

Recent SEC Comment – Non-GAAP

- “We note that the non-GAAP measures you have presented exclude material recurring items. The disclosure you have provided regarding your non-GAAP measures does not appear to adequately demonstrate the usefulness of the measures...you must meet the burden of demonstrating the usefulness any measure that excludes recurring items, especially if the non-GAAP financial measure is used to evaluate performance.”

Recent SEC Comment – “Cheap Stock”

- “Please revise your disclosure to include a more robust discussion regarding the items noted in paragraph 182 of the AICPA Practice Aid. Currently, we note your disclosure appears less specific than this guidance suggests for issuances on dates where you did not obtain a contemporaneous valuation...”

SEC Topics – Cash Flows

- SEC views Statement of Cash flows to be important
 - Covered by management's 404 certification
 - One of the primary financial statements
 - Used by stakeholders to understand the quality of earnings of a Company.
- Perceived lack of focus by preparers and reviewers on the classification of transactions

SEC Topics – Cash Flows

- FAS 95 – Reporting of Cash Flows
 - Few recognition issues
 - Statement reflects what actually happened
 - Few judgments or estimations
 - Classification statement only

SEC Topics – Cash Flows

- Problem Areas
 - Foreign Currencies
 - Restricted Cash
 - Derivatives
 - Debt Prepayment Penalties
 - Dividends

SEC Topics – Cash Flows

- Restricted cash
 - Not explicitly discussed in FAS 95
 - Companies have reflected changes in restricted cash in **all three** categories
 - Specific fact patterns could lead to a different answer, but presumption is that changes in restricted cash are an investing activity
- Debt prepayment penalties classified?
 - The prepayment penalty is deemed to be a payment of lost interest, therefore an interest payment – operating activity

SEC Topics – Registration Rights

- Penalties in the event of non-registration of shares:
 - Common in registered equity unit or convertible debt offerings
- Previously impacted classification of equity securities under EITF 00-19 – Issue Summary for EITF 05-4
- In December 2006, FASB issued FSP EITF 00-19-2
 - Provides for a FAS 5 model for recognizing the registration payment liability
 - Initial recognition will reduce proceeds allocated to other securities
 - Subsequent recognition or changes in value will be recognized in earnings.
- After applying the FSP - still need to assess liability/equity classification under EITF 00-19

SEC Topics – Preferred stock warrants

- FSP 150-5 effective for periods beginning after September 30, 2005
- Applies to warrants to purchase equity securities:
 - Underlying preferred (or common) stock must contain some provision requiring cash payment
 - Similar to ASR 268 provisions “Any condition requiring issuer to redeem in cash”
 - Standard CIC provision in VC preferred caught by FAS 150-5

SEC Topics – Preferred stock warrants

- Most warrants to purchase preferred stock are caught by the FSP:
 - Impact is that the warrant will be treated like a derivative
 - Classified as a liability, rather than equity
 - Reclassified to liability at fair value at date of adoption
 - Any difference between original value and value at date of adoption is recognized through a cumulative catch up adjustment.
 - Subsequent changes in value adjusted through income
 - Increases in value of preferred = charges through other income

SEC Topics – Hedge Accounting

- At the inception of a hedge, a company must formally document its hedge accounting relationship, as well as its risk management objective and strategy for undertaking the hedge.
- Documentation is sufficient when it is clear that all the criteria for hedging have been addressed.
 - No bright line to indicate what is "sufficiently clear," especially for complex transactions

SEC Topics – Hedge Accounting

- SEC view is “critical terms” must be perfectly matched.
 - If slight mismatch (under limited circumstances), entities required to demonstrate **quantitatively** that:
 - the hedging relationship is expected to be highly effective
 - ineffectiveness is expected to be de minimus
- Above accommodation is limited to situations described in SEC white paper
 - 30 days issue (i.e. match to month) of FX and commodity hedge.
 - CF hedge of variable rate debt with interest rate swap where reset dates match but not the payment dates.
- Applies to both previous and current hedge transactions.

SEC Topics – SAB 108

- Staff Accounting Bulletin No. 108 adopted September 13, 2006
- Requires a “dual-approach” to the quantification of unadjusted audit differences...Rollover Method & Iron-Curtain Method
 - Rollover – focuses on income statement
 - Iron Curtain – focuses on balance sheet
- The “higher-of” adjustment amount will be used to determine materiality, compared to the current period’s financial statements
- **Impact – lower tolerance for unadjusted differences**

SEC Topics – SAB 108

- Allows for a cumulative effect adjustment to beginning retained earnings
- An alternative to restatement of prior financial statements where:
 - Application of the dual method suggests that unadjusted differences, as of the date of adoption
 - Were material to the year immediately preceding adoption, or
 - Would be material if corrected and reported in results of operations in the year of adoption

SEC Topics – SAB 108

- Effective for years ending after November 15, 2006:
 - Calendar companies should have adopted as of December 31, 2006
 - June and September year end companies in 2007
 - FASB to issue similar guidance for private companies – to be effective for calendar 2007 year ends
- SAB 108 transition guidance is not available to companies filing an IPO

SEC Topics – SAB 108

- SAB 108 permits companies to correct prior year financial statements for immaterial errors the next time they are filed.
- However, the staff distinguishes between the materiality of an error and the materiality of the correcting entries.
 - This means financial statements may need to be amended promptly even if the correcting entries would be immaterial.

SEC Topics - Stock Based Compensation

- FAS 123 R
- Stock option back-dating

SEC Topics - Stock Based Compensation

- FAS 123R Adoption
 - All companies should now have adopted
- Challenges
 - Public companies
 - Application of forfeiture assumptions
 - Earnings per share impacts
 - Private Companies
 - Determination of volatility
 - Common stock valuation

SEC Topics - Stock Based Compensation

- Backdating of Stock Options
 - SEC letter of September 19, 2006 outlines potential problem areas of accounting for stock options
 - SEC letter issued in January 2007 provides guidance on restatements:
 - Outlines that all previous reports need not be re-filed if **all** the disclosures are included in current period restatement
 - Renewed focus on adequacy of internal controls over stock based compensation processes

Income Taxes

- Effective for 2007 fiscal years
- Scope of FIN 48 includes all entities subject to income taxes (including not-for-profits and pass-through entities).
 - Reasonable to assume that ALL entities will be impacted by FIN 48
 - Loss companies will be impacted
- All tax positions accounted for in accordance with FAS 109, including:
 - Previously filed positions
 - Expected filing positions
 - Decision not to file tax returns
 - Decision to exclude potentially taxable income
 - Choice made in classifying a transaction as tax-exempt (e.g., non-taxable spin-off)
 - Tax positions acquired or assumed in a business combination

Income Taxes

- FIN 48 requires the following disclosures:
 - Roll-forward of all unrecognized tax benefits (UTBs) set out in the form of a tabular reconciliation of the beginning and ending balances of the UTBs on a worldwide aggregated basis;
 - The total amount of UTBs that, if recognized, would affect the effective tax rate;
 - The total amount of interest and penalties recognized in the income statement and accrued on the balance sheet;
 - Discussion of reasonably possible changes in the UTBs in the next 12 months; and
 - Description of open tax years by major jurisdictions
- Tabular reconciliation is an annual disclosure – limited information provided in interim disclosures to date

Income Taxes

- FSP FIN 48-a (May 2007) provides three criteria for assessing if a tax position has been “effectively settled” with the taxing authority upon completion of the exam.
 - Taxing authority has completed its procedures
 - Company does not intend to appeal or litigate
 - Based on the taxing authority’s widely understood policy, it’s highly unlikely the position would be reexamined (presuming full knowledge of all relevant information)

Income Taxes

- Challenges:
 - Difficulty understanding and explaining new disclosures
 - Increased transparency, i.e., “roadmap” for taxing authorities
 - Potential for questions from users (regulators, analysts, shareholders)

Internal Controls

- Revised compliance deadlines
- SEC Guidance for Issuers
- New PCAOB auditing standard

New Compliance Deadlines

[SB061670.291]

Internal Controls – Compliance deadlines

- On December 15, 2006 the SEC adopted final rules that provide further deferrals of the reporting requirements of Section 404 for smaller public companies (i.e., non-accelerated filers) and newly public companies. Under the final rules:
 - The management reporting requirements of Section 404 become effective for non-accelerated filers for fiscal years ending on or after December 15, 2007.
 - The auditor reporting requirements of Section 404 become effective for non-accelerated filers for fiscal years ending on or after December 15, 2008.
 - The Section 404 management and auditor reporting requirements become effective for newly public companies beginning with their second annual report.

Internal Controls

- During the December 2006 Conference, Laura Phillips, PCAOB Deputy Chief Auditor, pointed out that although not issuing an opinion in year one, the auditor is associated with management's Section 404 report.
- In such a circumstance, the auditor must consider AU 550 and AU 9550 (SAS 8) Other Information in Documents Containing Audited Financial Statements, which instructs the auditor to read the report by management and consider whether it is materially inconsistent with information appearing in the financial statements, and in doing so may become aware of a material misstatement of fact.

SEC Interpretative Guidance for Management

[SB061670.291]

Internal Controls – SEC guidance

- Builds on the May 2005 clarifying guidance provided by the SEC and the PCAOB
- Focused on making the whole 404 process more efficient from:
 - Adjusting the nature, timing and extent of testing based on the evaluation of risk;
 - Increasing the use of the work of others;
 - Properly identifying and testing only the controls key to achieving the control objectives and financial statement assertions;
 - Integrating the audit.

SEC Proposal – Management’s Assessment

- Final Rules were released on May 23, 2007
- Guidance focuses on:
 - *Identification of risks to reliable financial reporting, and the related controls that management has implemented to address those risks.*
 - *Evaluation of the operating effectiveness of controls.*
 - *Reporting the overall results of management's evaluation.*
 - *Documentation.*

Internal Controls – SEC Guidance

- Lack of 404 guidance for management resulted in the unintended consequence of management using the auditor requirements in AS 2, which the SEC believes contributed significantly to the high costs incurred to date
- Guidance intended to increase the efficiency of the process, while preserving the substance and the benefits of 404
- Management's process of assessing the effectiveness of ICFR is intended to be driven by and tailored for the facts and circumstances of each company

Internal Controls – SEC Guidance

- No requirement of changes for companies that have already developed an effective approach
- Guidance was developed largely with the smaller companies in mind, but is expected to be beneficial to all
- Auditor opinion on management assessment eliminated

Internal Controls – SEC Guidance

SEC Guidance is based on two principles

- 1) Management should evaluate the design of the controls to determine whether there is a **reasonable possibility** that a **material misstatement** in the financial statements would not be prevented or detected in a timely manner
 - This principle allows management to focus on those controls that are needed to adequately address the **risk of a material misstatement** in the financial statements

Internal Controls – SEC Guidance

- 2) Management should gather and analyze evidence about the operation of the controls being evaluated based on its assessment of the risk associated with those controls failing
 - This principle allows management to **align the nature and extent of its evaluation procedures** with those areas of financial reporting that pose the **greatest risks** to reliable financial reporting

SEC Proposal – Management’s Assessment

- ***Identification of risks to reliable financial reporting and the related controls***
 - Risk-based approach that would require the use of judgment to determine those areas that are both material and pose a significant risk to reliable financial reporting.
 - Management would identify the controls that address those risks, including the risk of material misstatement due to fraud. It would be unnecessary to include additional controls within management's evaluation.

SEC Proposal – Management’s Assessment

- ***Identification of risks to reliable financial reporting and the related controls***
 - In assessing the control design, the guidance focuses on:
 - Identifying financial reporting risk specifically related to GAAP reporting and controls that adequately address those risks.
 - Consideration of entity-level controls and their relationship to the specific financial reporting element.
 - Role of relevant general information technology controls for both automated and IT dependent controls.
 - Reasonable documentation to support the assessment of the controls in operation

SEC Proposal – Management’s Assessment

- ***Evaluation of the operating effectiveness of controls***
 - For controls considered in scope, management must gather and analyze evidence about the operation of those controls using a risk-based approach based on the company's unique facts and circumstances.
 - The guidance allows management to support its evaluation in a variety of ways, and illustrates how management can consider and utilize
 - its existing daily interaction with its business,
 - direct testing of controls, including self-assessment, and
 - other ongoing monitoring activities.

SEC Proposal – Management’s Assessment

- ***Evaluation of the operating effectiveness of controls***
 - In the evaluation of operating effectiveness, management should assesses both the misstatement risk of a financial reporting element and the risk of a control failure.
 - In determining the misstatement risk of a financial reporting element, factors to be considered include:
 - Level of judgment required to determine the recorded amount.
 - Susceptibility to fraud.
 - Complexity in underlying accounting requirements.
 - Subjectivity to environmental factors, such as technological and/or economic changes.
 - Management must consider the risk at each location in order to determine how much testing is required to assess the operation of a control at each location

SEC Proposal – Management's Assessment

- ***Reporting the overall results of management's evaluation***
 - Management must decide if any identified control deficiencies, or combination of control deficiencies, are material weaknesses.
 - The guidance provides management with a framework for making these judgments, and includes situations that are considered strong indicators that a material weakness exists.
 - The guidance describes the factors that management should consider in order to evaluate the severity of a deficiency.
 - If the deficiency is a material weakness, consistent with the existing SEC rules, management must conclude that internal control over financial reporting is not effective.

SEC Proposal – Management’s Assessment

■ ***Documentation***

- The guidance explains the nature and extent of evidential matter that management must maintain in support of its assessment, including how management has flexibility.
 - Such documentation can take many forms, can be presented in a number of ways, and does not need to include all controls within a process that impacts financial reporting.
- The evidential matter maintained in support of the assessment would also include the methods and procedures utilized to gather and evaluate evidence, and the basis for conclusions.
- In situations where management is able to rely on its daily interaction with its controls as a basis for its assessment, management may have limited documentation created specifically for the evaluation beyond documentation regarding how its interaction provided it with sufficient evidence.

AS 5

[SB061670.291]

PCAOB's Proposed AS 5

- PCAOB approved, on May 24, 2007, their revised standard for the external auditor's assessment of internal control over financial reporting (ICFR) – still subject to SEC approval.
 - AS 5 is meant to replace AS 2 which was released in 2004. It is designed to enable the auditor to perform a more efficient integrated audit while maintaining the principles of AS 2.
- AS 5 focuses on the integrated audit being top-down and risk-based, rather than rules-driven. Several of the more specific requirements from AS 2 are eliminated.
- AS 5 incorporates the principles from the guidance issued by the PCAOB in May 2005 on how to improve efficiency in the performance of an audit of internal control over financial reporting.
- AS5 is expected to reduce audit fees for most companies.
 - The extent of reduced audit fees will depend on the specific circumstances for each individual registrant.

PCAOB's Proposed AS 5

Key Points:

- Top-down and risk-based approach for identifying significant accounts and key controls.
- Risk-based approach for ITGC .
- Multi-location scoping based on risk instead of coverage.
- More flexibility in the ability to use the work of others.
- Increases the auditor's ability to use results of prior integrated audits in determining the nature, timing and extent of the current year audit work.
- Scaling of the audit for the size and complexity of the company.
- “Recalibrates” the walkthrough requirement.
- Eliminates separate opinion on management's assessment.
- Revise definitions of material weakness and significant deficiency.

PCAOB's Proposed AS 5

Top-down and risk-based approach for identifying significant accounts and key controls

- Auditor should only test those controls necessary to obtain reasonable assurance about whether material weaknesses exist – direct attention to the most important controls that support relevant Financial Statement assertions.
- Begins with entity-level (company-level) controls, with particular emphasis on the control environment, risk assessment process, period-end reporting process, controls over management override, and anti-fraud controls.
- Works down, as appropriate, to significant accounts and disclosures, relevant financial statement assertions, and significant processes.
- Attention should be on accounts, disclosures and financial statement assertions that present a **reasonable possibility** of a **material misstatement** to the financial statements.

PCAOB's Proposed AS 5

Top-down and risk-based approach for identifying significant accounts and key controls (cont.)

- Identify significant accounts and disclosures based on quantitative and qualitative risk factors.
- Evaluate the components of each significant account based on risk.
- For each significant account, determine which financial statement assertions are relevant, considering sources of potential material misstatements.
- The auditor should use the understanding of risk obtained as part of identifying significant accounts when identifying relevant assertions, major classes of transactions and significant processes, as well as when selecting the controls to test.

PCAOB's Proposed AS 5

Risk-based approach for ITGC

- Risk-based approach applies similarly to information technology general controls supporting the automated and IT dependent controls.
 - Perception that the auditor has spent too much time on lower risk areas.
 - Approach tailored to those areas that directly relate to automated and IT dependent controls supporting financial statements assertions.
- “Benchmarking” guidance for automated controls, including factors to be considered in determining whether to use a benchmarking strategy.
- Reaffirms the auditor’s need to understand the impact of information technology on the flow of data and transactions and references to AU 319.

PCAOB's Proposed AS 5

Risk-based approach for Separate Locations

- Assess the risk of material misstatement to the financial statements associated with locations:
 - Refocus on risk rather than coverage (**eliminated “large portion” of coverage requirement from AS2**)
- Correlate the amount of audit attention devoted to the location with the degree of risk
- Eliminate further consideration of locations that do not present a reasonable possibility of material misstatement
- For lower-risk locations, evaluate whether testing entity-level controls provides sufficient evidence

PCAOB's Proposed AS 5

More flexibility in the ability to use the work of others

- AS 5 lists the following as areas where the auditor may use the work of others.
 - Procedures the auditor performs when obtaining an understanding of the company's internal control over financial reporting, e.g. "walkthroughs".
 - Procedures the auditor performs when testing the effectiveness of controls, including **control environment**.
 - Substantive procedures the auditor performs when testing account balances and disclosures.
 - Only area that the auditor is required to test is controls over period end reporting.
- **Eliminates AS 2's "principal evidence"** requirement.

PCAOB's Proposed AS 5

Using the work of others (cont.)

- When using the work of others the auditor must:
 - Evaluate the nature of the subject matter tested by others,
 - Evaluate the competence and objectivity of the individuals who performed the work, and
 - Test some of the work performed by others in order to evaluate the quality and effectiveness of their work.
- The auditor should not use tests performed by the same personnel who are responsible for performing the control or for the completeness and accuracy of the information being tested, because these individuals do not have sufficient objectivity as it relates to the subject matter.
- The level of reliance on management's testing will change based on the risk of the control and the competency/objectivity of the tester.

PCAOB's Proposed AS 5

Increases the auditor's ability to use results of prior integrated audits in determining the nature, timing and extent of the current-year audit work.

- Eliminates statement in AS 2 that *"each year's audit must stand on its own"*. (Note: Rotation is still not allowed)
- The auditor should apply judgment and incorporate knowledge obtained during past audits in determining the nature, timing and extent ("NTE") of testing necessary.
 - The NTE of procedures performed in previous audits.
 - The results of the previous years' testing of the control.
 - Changes in the control, or the significant process in which it operates, since the previous audit.
- The lower the risk of a control, the less evidence the auditor needs to obtain in the subsequent years' audits (vice versa).

PCAOB's Proposed AS 5

Scaling of the audit for the size and complexity of the company

- The auditor should tailor the audit for the company's size and complexity.
- Describes attributes of smaller, less complex companies:
 - Few business lines.
 - Less complex business processes and financial systems.
 - Centralized accounting functions.
 - Extensive involvement by senior management in day-to-day activities.
 - Few levels of management, each with a wide span of control.
- Such companies achieve many of their control objectives through daily interaction of senior management with company personnel rather than through formal policies and procedures.

PCAOB's Proposed AS 5

“Recalibrates” the walkthrough requirement

- Scope is *each significant process* rather than each major class of transaction within each significant process.
- Objectives of a design testing remain substantially the same.
 - Understand the flow of transactions
 - Identify risks of misstatement
 - Identify controls to address those risks
 - Identify other fraud related controls
- While a walkthroughs would satisfy objectives, other procedures may be equally or more effective in achieving those objectives.
- Allows the auditor to utilize the direct assistance of others, to assist with the walkthrough
 - Auditor should independently perform or supervise the work of others who provide direct assistance.

PCAOB's Proposed AS 5

Eliminates auditor's separate opinion on management's assessment

- The separate auditor opinion on management's assessment has been eliminated.
- The auditor's report is no longer required to include a description of material weaknesses (permitted to reference the disclosure in management's report).

PCAOB's Proposed AS 5

Fine-tune definitions of material weakness and significant deficiency

- AS 5 provides indicators of a material weakness, which in practice are generally equivalent to the prior standard.
- Under certain circumstances, despite these indicators, management and the auditor may determine that no deficiency exists.
- Replaces the term "more than remote likelihood" with the term "reasonably possible" within the definition of a material weakness.
 - While this represents a change to the language, no change has been made to the conceptual threshold (SFAS 5 reference).
- Replaces the term "more than inconsequential" in the definition of a significant deficiency.
 - Significant deficiency is defined as "less than material yet important enough to merit attention by those responsible for oversight of the company's financial reporting".

Comments Made by PCAOB Regarding AS 5

Does:

- Require significant judgment
 - Principles-based
 - Heavily risk-based
- Eliminate unnecessary work
- Incorporate May '05 efficiency principles
- Introduce scalability for smaller companies
- Simplify the requirements
- Anticipate cost savings

Does Not:

- “Water-down” the principles in AS 2
- Propose design-only evaluation
- Allow rotational testing
- Create different standards for smaller companies
- Reduce costs by a standard percentage for all companies

SEC Proposal – Management’s Assessment

- ***Interaction between SEC’s proposal for management’s assessments and the PCAOB standard for the auditor’s assessment***
 - The SEC guidance includes a large degree of flexibility to management in determining what procedures to perform and what evidence to obtain in order to evaluate the operational effectiveness of controls.
 - The proposed PCAOB standard allows the auditor increased flexibility in relying on the work of management in assessing the effectiveness of internal control over financial reporting.
 - As a result, management and the external auditor need to coordinate closely to obtain the maximum effect from the increased flexibility.

Realizing the Benefits of the New guidance

- Management's assessment process
 - Starting point should be to consider the impact of the SEC interpretive guidance on management's plan for assessing ICFR
 - Quality of management's assessment inherently linked to the amount of work that the auditor will need to do
 - The better management's evaluation process, the more the auditor can rely on the work of management
- Using a top-down approach
 - Focus on only the key controls that prevent or detect material misstatements
 - Increased consideration of the impact of effective company-level controls
 - More reliance on effective monitoring controls to reduce process-level testing