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THE 2010 AICPA SEC AND PCAOB CONFERENCE

The annual AICPA National Conference on Current SEC and PCAOB Developments held on December 6-8, in Washington, DC, provided insights into the Securities and Exchange Commission (SEC) staff's views on various accounting and reporting issues. The remarks made by SEC Chairman Mary Schapiro and members of the Office of the Chief Accountant and slides presented by the Division of Corporation Finance may be accessed at the SEC's website, *www.sec.gov*, under Speeches & Public Statements.

OVERVIEW

"Change is coming" was a major theme of the 2010 conference. Regardless of whether the U.S. ultimately adopts International Financial Reporting Standards (IFRS), change in accounting is inevitable. The Financial Accounting Standards Board (FASB), through its convergence projects with the International Accounting Standards Board (IASB), is considering sweeping and controversial changes to U.S. Generally Accepted Accounting Principles (GAAP) – changes that would impact the underlying conceptual framework as well as key areas, such as revenue recognition, lease accounting, and financial instruments.

In light of the magnitude of the proposed changes, the SEC staff urged all stakeholders – investors, preparers, analysts, and auditors – to actively participate in the standard-setting process. To this end, all interested parties – small and large – were encouraged to keep abreast of the accounting issues and to share their views and insights through the comment process and other outreach activities.

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Registrants were also advised to begin assessing the impact of the proposed accounting and any organizational changes that may be necessary (e.g., modifications to information systems, changes in business model). Although redeliberations and further refinements to the exposure drafts are expected in response to the comment letters, the FASB is still hopeful that standards on high priority projects, such as revenue, leases and financial instruments, will be finalized in 2011. A comprehensive and well-considered adoption, for some of these standards, could ultimately require an organization-wide commitment and significant time and effort.

The following comments provide additional insight into the SEC positions on this and other accounting and reporting issues.

INTERNATIONAL FINANCIAL REPORTING STANDARDS

The SEC continues to support the goal to establish one set of high-quality global accounting standards, and views the convergence process between the FASB and the IASB as a top priority and critical step towards achieving this goal. The Boards were commended by the staff on the progress to date and their intensified efforts to jointly deliberate issues and work through unified project teams, a collaborative approach, which was described as a model for how convergence can and should be addressed.

However, the staff cautioned that convergence is only acceptable if the resulting standards are high-quality, comprehensive, sustainable, and uniformly applied. Although expanding efforts to achieve the goal of convergence in a timely manner is important, convergence without adequate due process and field testing is not an acceptable result, nor one that would serve the interests of investors and the capital markets in the long run.

Nevertheless, Chairman Schapiro was optimistic that a convergence that would benefit both U.S. investors as well as those throughout the world can be achieved. She believes a decision will be made by the SEC in 2011 as to whether and how IFRS should be incorporated into the U.S. reporting system, although not necessarily by the June 2011 timetable, which is the date set by the Boards in their Memorandum of Understanding for completion of the more significant convergence agenda items. If the SEC ultimately decides to adopt IFRS, an implementation/transition period of at least four years is expected (i.e., not effective before 2015).

RESTORING PUBLIC TRUST

Financial reporting, that is both accurate and transparent, is the foundation for successful capital markets. Only transparent and complete disclosures provide investors with the tools necessary to make informed investment decisions. And it is these decisions that enable markets to efficiently allocate the capital needed for innovation and growth.

But the scandals and crises of the last decade have shaken the public's trust in the U.S. capital markets. Restatements, misleading "window-dressing" in quarterly reports, and off-balance sheet exposures have caused investors to lose confidence in the reliability of financial information. As a result, Chairman Schapiro and the SEC staff asked preparers and auditors to be their allies in restoring public trust by producing disclosures that, in addition to being accurate, provide a full and fair picture of a company's financial position and operations.

Additionally, consistent with prior years, the staff reminded registrants that if financial reporting is to present a true and unvarnished assessment of a company's financial condition, it must faithfully and accurately reflect the substance of transactions. Accounting should not be inappropriately applied in an effort to manage results (e.g., targeted net income, leverage) and transactions should not be structured solely to achieve an accounting objective.

SEC RULES

NON-GAAP MEASURES

In early 2010, the SEC staff revised its interpretive guidance on non-GAAP measures. The changes were in response to a concern that the prior staff positions were understood to be more restrictive than originally intended by the rules and, consequently, were inappropriately prohibiting disclosure of information that would be useful to investors.

The SEC staff reflected on the changes in registrant behavior during the last year as a result of the revised interpretations. They acknowledged that the new guidance removed some of the barriers to providing disclosures and that as a result registrants were providing more non-GAAP information in filed documents. But they noted that non-GAAP measures continue to be concentrated in communications, such as earnings releases or investor calls, which are not filed with the SEC.

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Although companies were not encouraged to use non-GAAP measures in their filings, they were encouraged to be consistent in their message. If non-GAAP measures are considered to be key benchmarks critical to understanding the business and a focal point when communicating with investors (e.g., earnings releases, investor calls) the staff would expect them to be addressed in some fashion in reports filed with the SEC (e.g., Forms 10-K or 10-Q). In the staff's view, these filings are communication documents – not simply compliance documents – and the revised interpretations now allow registrants to align their MD&A disclosures with other investor communications.

The staff also highlighted certain aspects of the rules and interpretive guidance that are often overlooked or misapplied:
- GAAP measures should be disclosed with equal prominence as the non-GAAP measures (i.e., non-GAAP measures are not a replacement for GAAP).
- Non-GAAP measures should be accompanied by an explanation as to their usefulness and reconciled to the comparable GAAP measures.
- The denominator in non-GAAP diluted earnings per share should be reassessed (i.e., common stock equivalents should be considered) if the non-GAAP measure is income and the GAAP measure is a loss.
- Non-GAAP measures that are misleading, such as cash flow per share, are not permitted in communications, including those that are not filed with the SEC.

Registrants were also advised that assessing materiality of accounting errors solely in terms of non-GAAP measures (e.g., impact on EBITDA) is inappropriate. All information, which includes the impact on GAAP financial statements, must be considered. However, if an error is material to a non-GAAP measure, which under SEC rules is defined as misleading, restatement would be required.

SIGNIFICANCE TEST

Rule 1-02(w) of Regulation S-X provides computational guidance for determining the significance of other entities (e.g., acquired company, equity method investee). The significance of these other entities, relative to that of the registrant, is computed using three different measures – investment, total assets, and income (i.e., pre-tax income/loss from continuing operations). Depending on the significance, separate financial statements or summarized financial information may be required. In 2010, the SEC staff reconsidered and significantly revised its guidance regarding the income test as described below:
- Income averaging – the provision allowing registrants, in certain circumstances, to use a five-year income average has now been extended to registrants with a loss in the most recently completed fiscal year. Consistent with prior guidance, any loss years would be replaced with a zero when computing the average.
- Equity method investee – the registrant's proportionate share of income or loss will now be based on the financial statements of the investee and adjusted only for any basis differences (i.e., push down of acquisition method). Other items typically reflected as equity earnings in a registrant's financial statements (e.g., gains/losses on sales of investee stock, impairments at investor level) will no longer be considered. Financial statements for prior years will not be required if, under the revised guidance, the equity investee would have been insignificant.
- Disposal of business – the income or loss of the disposed business will now be included in the denominator if it does not qualify as a discontinued operation and excluded if it does.

SUMMARIZED FINANCIAL INFORMATION

Summarized financial information under Rule 4-08(g) of Regulation S-X is generally required for equity method investees that meet certain significance levels. Questions have arisen as to how to compute significance and what information to provide when different bases of accounting are used by the registrant and the investee.

The SEC staff clarified that the determining factor is the basis of accounting used by the registrant. For example, if the registrant is a domestic issuer whose financial statements are prepared under U.S. GAAP and the investee is a foreign business with financial statements prepared under home country GAAP, the registrant's share of the income of the foreign business (the income test described above), as well as any summarized financial information required, should be based on U.S. GAAP. Summarized financial information provided under home country GAAP – even if accompanied by a statement that differences between the bases of accounting did not materially impact the registrant's financial statements – is not acceptable.

GUARANTOR FINANCIAL STATEMENTS

As a general rule, every issuer and guarantor of a registered security is required to file the financial statements that would be required of a registrant under Regulation S-X. For example, if a parent registers debt instruments that are guaranteed by its subsidiaries, separate financial statements of the subsidiaries would generally be required. However, Rule 3-10 of Regulation S-X allows a registrant to present consolidating financial information in a footnote in lieu of separate financial statements if certain criteria are met. To qualify for this relief: (a) each of the subsidiary guarantors or issuers must be 100% owned by the parent, (b) the guarantees must be full and unconditional, and (c) if there are multiple guarantors, the guarantees must be joint and several.

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The SEC staff provided some insight into how the terms should be interpreted and the rule applied through the following examples. Ownership should not be assessed solely in terms of voting control. If a contractual arrangement allows holders of non-voting shares to appoint directors to the board of a subsidiary, the subsidiary would not be considered 100% owned. Similarly, full and unconditional should not be assessed solely in terms of the extent of the guarantee but also the duration. If a guarantee is not in place continuously throughout the life of the registered security (i.e., a guarantor can "opt out" of the guarantee during the term of the debt) it would not be considered full and unconditional. The staff reminded registrants that failure to satisfy the criteria would require full registrant financial statements for all guarantors as well as separate Exchange Act reporting.

CRITICAL ACCOUNTING ESTIMATES

The SEC staff identified two accounting estimates that they believe may warrant expanded disclosure in the critical accounting estimates section of MD&A – goodwill impairment testing and, for companies going public, stock-based compensation. Both estimates generally meet the definition of critical since they require significant judgment (i.e., relate to highly uncertain matters susceptible to change) and have the potential to materially impact a company's financial condition or operating performance.

GOODWILL IMPAIRMENT

Consistent with last year's conference, the SEC staff indicated that registrants should expand the disclosures for each reporting unit that has material goodwill and is at risk of failing the first step in a goodwill impairment assessment (i.e., a fair value that is not substantially in excess of its carrying value). For these reporting units the disclosures should include: (a) the percentage by which fair value exceeded carrying value, (b) the amount of goodwill allocated to the reporting unit, (c) the key assumptions that drive fair value, and (d) any uncertainty or potential events that could negatively effect the key assumptions.

The staff would expect the disclosures to be more expansive when indicators of impairment appear to exist (e.g., book value greater than market capitalization). In other words, if it is unclear why an impairment is not recorded, additional disclosures are warranted. These disclosures would not be required if registrants assert and disclose that there are no reporting units at risk or no material goodwill balances within reporting units at risk.

STOCK-BASED COMPENSATION IN AN INITIAL PUBLIC OFFERING (IPO)

Determining the fair value for equity awards can be complex and highly subjective, particularly when the shares underlying the grants are not publicly traded. Even when registrants follow best practices and obtain independent and contemporaneous valuations, the resulting fair values are generally based on unobservable inputs (e.g., financial forecasts or multiples of earnings). As such, disclosures addressing the valuation methodology and underlying assumptions are particularly useful in understanding how the fair values were derived and any significant fluctuations in fair value that have occurred (i.e., historical estimates versus estimated IPO price).

With this in mind, the SEC staff advised companies going public to include transparent disclosures that provide insight into the development of the fair values. The disclosures should address the twelve months preceding the latest balance sheet and, at a minimum: (a) describe the methods and assumptions used, (b) display the grant activity in a tabular format (e.g., number of grants, exercise price, fair value of award and underlying share), and (c) discuss the factors contributing to changes in fair value. Registrants should focus on significant values and changes in values that appear to be inconsistent with the operations and development of the company.

If meaningful, this disclosure should be expanded beyond the twelve month period. Circumstances that may warrant such expanded disclosure could include, among other things, a significant number of grants or changes in fair value since the latest balance sheet or an estimated IPO price that significantly differs from the most recent fair value determination.

ACCOUNTING

The SEC staff addressed a number of accounting issues, but prefaced the discussions with a cautionary word regarding the objectives and limitations of their speeches. The speeches focus on some of the most challenging accounting areas that individuals are currently dealing with in practice. In the view of the staff, they are not intended to establish GAAP or provide definitive answers. Rather, they are provided as examples of thought processes used by the staff when analyzing transactions and applying GAAP and approaches that registrants should consider when performing their own evaluations of specific fact patterns and arrangements.

The speeches have a limited shelf life since as GAAP changes so would the analysis and conclusion. The speeches also have limited applicability (i.e., cannot be universally applied to all situations), since they are based on specific facts and circumstances and as fact

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patterns change so may the conclusions. With this as a backdrop, the staff discussed the following accounting issues – consolidation, liability versus equity, debt extinguishment and derecognition for the transfer of a business.

CONSOLIDATION

Under ASC 810 (formerly FAS 167), a reporting entity must consolidate a variable interest entity (VIE) in which it has a controlling financial interest. Specifically, consolidation is required if an enterprise has both: (a) the power to direct the activities of the entity that most significantly impact an entity's economic performance and (b) exposure to losses and benefits (rights and obligations) that potentially could be significant to the entity. In this standard, effective 2010 for calendar year companies, the FASB took a more principles-based approach – one that requires qualitative-based assessments and judgments in determining whether a VIE should be consolidated.

The SEC staff reflected on the implementation process and provided some observations on how to apply the principles in practice:

- Power – power should be based solely on participating rights – not on protective rights – and the examples of protective rights (both in ASC 810 and throughout GAAP) should be considered when distinguishing between the two. All sources of power should be considered (e.g., activities by management, servicing or financing arrangements) and an analysis of decisions made at inception may be necessary (e.g., an entity's formation documents). Any assertion that power is shared, which would require that the parties together have the power to direct the activities with the consent of the other, should be approached with a high degree of skepticism.
- Benefits – questions as to whether rights and obligations are significant to the entity should be resolved through a qualitative assessment that weighs the particular facts and circumstances. The staff has not developed any bright lines in this regard and would consider such an approach contrary to the objectives of the standard.
- Activities of the entity – all significant activities should be identified and considered. For example, if an entity is designed to hold financial assets to maturity and fund those assets by rolling over short-term debt financing, its activities would not only be those associated with the initial debt but also those associated with rolling over the debt or selling the assets and liquidating the arrangement. In certain situations, it may be appropriate to consider a group of activities when identifying activities that significantly affect economic performance.

Overall, registrants were urged to apply common sense and base their analyses and conclusions on the specific facts and circumstances.

LIABILITY VERSUS EQUITY

ASC 815-40 (formerly EITF Issue 07-5), effective 2009 for calendar year companies, provides guidance on assessing whether financial instruments should be accounted for as equity instruments or liabilities reflected at fair value. Under ASC 815 (formerly FAS 133), fair value accounting is not required for embedded conversion options and freestanding warrants if they are both: (a) indexed to a company's own stock and (b) classified in shareholders' equity. The EITF guidance was intended to provide a framework for assessing whether a financial instrument is indexed to a company's own stock. In actuality, it represented a significant change in accounting and its application resulted in many financial instruments – primarily warrants and embedded conversion options – being accounted for as liabilities rather than equity instruments.

The guidance focuses on settlement provisions and a general premise that in order to be considered indexed to a company's share, a fixed obligation must ultimately be settled with a fixed number of shares. Specifically, unless one of the following two conditions is met, liability accounting is required:

- Both the price (e.g., exercise price, conversion price) and the number of underlying shares are fixed (known as a fixed-for-fixed model).
- The terms are not fixed but the variables are inputs that would be considered when determining the fair value of a fixed-for-fixed option or forward contract. The staff suggested registrants consider the common inputs to a Black Scholes computation as a practical starting point in any analysis.

The SEC staff noted that registrants are not properly applying the guidance and that many instruments with variable settlement provisions are improperly accounted for as equity instruments. Commonly overlooked provisions that require liability accounting include: (a) down-round or re-set provisions in which the strike price is adjusted downward in connection with a subsequent issuance of shares and (b) instruments with exercise or conversion prices denominated in a currency other than the functional currency of the company. The staff encouraged registrants to carefully read the underlying documents and consider all the terms and provisions. And registrants were urged to replace generic disclosures (e.g., references to "standard anti-dilution provisions") with more transparent disclosures that highlight and describe the specific provisions.

Additionally, the methods used in valuing such instruments are oftentimes inappropriate. Black Scholes, which is frequently used, is a static model and therefore only appropriate for instruments with fixed provisions. Instruments with terms that are subject to change should be valued using a dynamic model, such as a lattice model or Monte Carlo simulation, which accommodates variability.

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DEBT EXTINGUISHMENT

The SEC staff has fielded a number of questions regarding the extinguishment of debt in non-troubled debt situations. The questions have focused on the guidance in U.S. GAAP that states that "extinguishment transactions between related entities may be in essence capital transactions" and, in particular, whether certain arrangements should be accounted for as gains or capital contributions.

The staff stressed that there are no bright-line views on these types of transactions. The specific facts and circumstances must be analyzed and the underlying substance of the transaction considered when determining the appropriate accounting. By way of example, the staff discussed a fact pattern in which a related party, who held non-convertible debt, accepted an offer to exchange the debt for common stock with a value significantly lower than the carrying value of the debt.

When analyzing the transaction the staff considered: (a) the role of the related party in the transaction, (b) why the related party would accept common stock of lesser value, and (c) whether the arrangement was in substance a forgiveness of debt. In this fact pattern the staff concluded that the arrangement was in substance a capital contribution from a related party. However, the staff stressed that gain recognition may be appropriate in other fact patterns. Registrants were advised to perform a similar analysis and consider all facts and circumstances, as well as the relationship with the related party, when analyzing such transactions.

DERECOGNITION UPON TRANSFER OF A BUSINESS

Under U.S. GAAP businesses should be derecognized or deconsolidated when the parent ceases to have a controlling financial interest. Although the guidance was originally limited to businesses that were separate legal entities, it was subsequently expanded through ASU 2010-2 to include groups of assets constituting businesses. This expansion in guidance was based on the notion that the accounting should be consistent regardless of the form of a business (i.e., whether a group of assets or a separate legal entity).

The SEC staff indicated that this same approach – consistent application of GAAP regardless of form – should be applied when assessing whether the transfer of a business meets the criteria for derecognition. By way of example, the staff discussed a situation in which a registrant transferred a business, that was not held in a legal entity, to a third party along with a put option that could require the registrant to repurchase the business in the future at the same initial purchase price. Until the option became exercisable, the registrant continued to operate the business under a management agreement that could be extended if the put option was not exercised. Although the registrant considered whether the third party was a VIE that required consolidation – and concluded it did not – it reflected a gain on sale without ever considering whether derecognition was appropriate.

In this fact pattern, the SEC staff believed that the registrant retained the risks and rewards of the business (cash flows) through the management agreement. In the staff's view, this continuing involvement was essentially the retention of a controlling financial interest that would preclude derecognition and gain recognition.

DISCLOSURES

Standard-setters are tasked with issuing standards designed to improve financial reporting. But some have questioned the recent tendency of the FASB to require extensive and prescriptive disclosures in both annual and interim financial statements (i.e., disclosure overload). The SEC staff suggested that this detailed approach to disclosure might be unnecessary if registrants respected the "spirit" of financial reporting and strived to provide financial information, beyond the minimum requirements, that was useful to users of financial statements (e.g., investors, lenders, and creditors).

In this regard, the staff provided some guidelines for registrants to consider when drafting disclosures. First, disclosures that are required (e.g., range of losses for reasonably possible contingencies) must be provided. Second, factors to consider (e.g., triggers for impairment testing) should be viewed as examples and not an all-inclusive list. Third, disclosures that are encouraged but not required should be provided if they would be important to users. And finally, in the absence of specific requirements or guidance, disclosures consistent with the underlying spirit of financial reporting should be provided.

The SEC staff reminded registrants that disclosures should be viewed as a communication tool and not a "check the box" exercise. Full and fair disclosures would enhance comparability, provide additional transparency, and help users understand material events both in terms of their effect on financial statements and any remaining uncertainties. Absent such a cultural change, the FASB may have no choice but to continue to require long lists of prescriptive disclosures that cannot fully contemplate every unique situation a registrant may encounter.

LOSS CONTINGENCIES

Disclosures regarding loss contingencies are required under both U.S. GAAP (ASC 450) and SEC rules (Item 103 of Regulation S-K). Although both alert readers to potential losses that may occur, the specific objectives and disclosure requirements are different. As such, the SEC staff

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cautioned registrants against replicating the Item 103 disclosure in the footnotes to the financial statements and reminded them of the ASC 450 requirements and their obligations to comply.

Disclosures are required for contingencies that are at least reasonably possible, even if the criteria for accrual are not met (i.e., not probable and estimable). The disclosures should indicate the nature of the contingency and provide either an estimate of the possible loss (an amount or range) or a statement that an estimate cannot be made. The SEC staff believes registrants may satisfy these requirements by: (a) disclosing an estimated loss or range, (b) stating the amount would be immaterial to the financial statements, or (c) stating that an amount cannot be estimated.

However, if a registrant chooses to state that the amount cannot be estimated – in lieu of disclosing an amount/range or stating that the amount would be immaterial – it must first make a concerted effort at estimating the loss and reassess its position each period end. As facts and circumstances change, the staff would expect the disclosures to change as well. Failure to provide the required disclosure because an estimate cannot be made with any "certainty" or "confidence" is neither consistent with GAAP (i.e., a level of precision is not considered in ASC 450) nor an argument accepted by the staff.

Registrants were reminded that the disclosures may be in the aggregate (i.e., losses on a claim by claim basis are not required). And the staff stressed that registrants are expected to comply with the existing standards under U.S. GAAP and the lack of historical disclosures may be questioned by the staff if settlements are disclosed in future periods.

INTERNATIONAL

US GAAP KNOWLEDGE

In 2010, the SEC staff saw a significant increase in domestic issuers with substantially all of their operations conducted outside the US. These companies generally became issuers as a result of backdoor registrations involving the merger of a private operating company with a U.S. public shell. Management assessments for such issuers typically concluded that internal control over financial reporting was effective.

The SEC staff issued comment letters to these registrants to: (a) determine the background and training of the CFO or person responsible for maintaining the books and records and preparing the financial statements and (b) assess and evaluate the registrant's experience with, and knowledge of, U.S. GAAP. The letters requested information regarding the nature of U.S. GAAP experience (e.g., education, training, professional qualifications); the roles and duties of persons with U.S. GAAP experience; and the services – both nature and extent – provided by any third-party CPA or consultant.

The goal of the letters was twofold – to disclose material weaknesses, if appropriate, in the short-term and to improve the overall qualify of financial reporting in the long-term. Although the initial targets were domestic issuers since they were required to prepare financial statements in accordance with U.S. GAAP, the staff indicated that similar comments may be sent to foreign private issuers in the future.

IFRS FOR SMES

In 2009, the IASB approved IFRS for Small and Medium-Sized Entities (known as IFRS for SMEs). It is only available for entities that do not have public accountability (e.g., debt and equity instruments are not traded in a public market) and eliminates many of the measurement and disclosure complexities that exist in IFRS. The SEC staff has concluded that IFRS for SMEs represents a comprehensive basis of accounting and indicated that it will be treated in a manner similar to home-country GAAP with some additional caveats as described below.

Specifically, IFRS for SMEs may only be used for financial statements of non-issuers that are foreign businesses (e.g., Rule 3-05 financial statements for acquired companies/targets or Rule 3-09 financial statements for equity method investees). It may not be used for financial statements of issuers, predecessors of issuers, domestic businesses, or domestic investees. And if a reconciliation under Items 17 or 18 of Form 20-F is required (i.e., significance is greater than 30%), the financial statements must be reconciled to U.S. GAAP, even if the registrant prepares its financial statements under IFRS.

IFRS AS ISSUED BY THE IASB

The staff reminded registrants and auditors that the assertion of "IFRS as issued by the IASB" must appear in both the financial statements and the audit report, since its inclusion is a condition for omission of the U.S. GAAP reconciliation.

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