

**BDO Seidman, LLP**  
Accountants and Consultants



# Financial Reporting

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## Report on the AICPA SEC and PCAOB Conference

The 2006 annual AICPA National Conference on current SEC and PCAOB Developments was held in Washington, D.C. on December 11-13. At the conference, the SEC staff shared its views on various complex accounting and reporting matters that it believes registrants and auditors should focus on this reporting season. The remarks made by the Chief Accountant, Conrad Hewitt, the Deputy Chief Accountants – Julie Erhardt, Zoe-Vonna Palmrose, and Scott Taub, members of the staff of the Office of the Chief Accountant, and certain members of the staff of the Division of Corporation Finance may be accessed at the SEC’s web site: <http://www.sec.gov/news/speech/speecharchive/2006speech.shtml#2fourthq>.

### Conference Themes

At this year’s conference, the speakers continued to focus on the complexity of financial reporting and the need for disclosure that communicates information to users in a clear and transparent manner. However, one of the SEC staff’s key messages was that despite the volume and complexity of the accounting rules, appropriate professional judgment is an important part of “preparing, auditing, and understanding high quality financial statements.” Scott Taub, the Deputy Chief Accountant, noted that following the rules that

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do exist is not inconsistent with applying professional judgment. In applying rules-based standards, professional judgment is needed to determine where within the scope exceptions and guidance the company's transaction falls. He further noted that accountants apply professional judgment, just a different type, when the standards rely more on principles and subjective analyses.

Mr. Taub noted that the staff believes that the bright-lines that do exist in the standards must be respected. This means that the staff:

- Will ask registrants to capitalize a lease even if it just barely exceeds the 90% threshold, but won't ask a company to capitalize a lease that has minimum lease payments equal to 89% of the fair value of the leased asset.
- Will accept the shortcut method for testing the effectiveness of a hedge when a company has met all of the criteria, but won't accept application of the shortcut method when a company has met all but one of the necessary criteria.

Mr. Taub further observed that when the literature says to use a best estimate, to consider available information, or to assess the likelihood of something occurring, then judgment must be used. Also, when the literature is unclear, it is necessary to apply professional judgment to determine the appropriate accounting model. He revisited a theme from last year and stressed that this does not mean structuring a transaction around the literature to achieve the desired accounting.

The staff commented that preparers can avoid second guessing by considering, assessing, and documenting all of the relevant facts and conclusions and disclosing that conclusion. Mr. Taub noted that,

"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."

## Uncertain Tax Positions

FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes*, becomes effective at the beginning of fiscal years beginning after December 15, 2006. The Interpretation allows companies to recognize the benefit of uncertain tax positions in their financial statements only if those positions are more likely than not to be ultimately sustained based on technical merits and ignoring the probability of the position being reviewed by a taxing authority.

The SEC staff discussed the application of its interim reporting rules, Rule 10-01(a)(5) of Regulation S-X, to FIN 48. If a new accounting pronouncement is adopted during an interim period, this rule requires all of the disclosures required by the pronouncement to be provided in the financial statements in the interim period of adoption and in subsequent interim periods until annual financial statements are filed on Form 10-K. The staff observed that it was not the FASB's intent to require a roll forward of the tabular reconciliation of unrecognized tax benefits (FIN 48, paragraph 21a) in interim periods. The staff believes that that the reconciliation need not be provided in the interim period in which FIN 48 is adopted. However, companies should disclose any material period-to-period changes in unrecognized tax benefits in the subsequent interim period financial statements

before annual financial statements are filed.

FIN 48 requires companies to record interest and penalties on unrecognized tax benefits. The staff believes that if a company changes its policy for the income statement classification of interest and penalties upon adoption of FIN 48, a preferability letter (Regulation S-K, Item 601(b)(18)) is *not* required. The staff also believes that companies making such a change in classification in the period of adoption are not required to justify it under paragraphs 13 and 14 of FASB Statement No. 154, *Accounting Changes and Error Corrections*.

The staff observed that FIN 48 does not provide prescriptive guidance on the quantity or type of documentation required to comply with FIN 48's recognition or measurement provisions. FIN 48 does not place any limits on the types of evidence a company can look to in making its recognition determinations. A company should consider among the sources of available evidence both informal and formal guidance from taxing authorities and other sources, and then weigh the items based on their persuasiveness. The staff also commented that a company should not lose sight of common sense and reasonable judgment in implementing FIN 48. For example, detailed analysis and documentation is *not* necessary for a company to support "obvious" tax positions.

The staff reminded registrants to provide the disclosure required by SAB 74 (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*. As the effective date of FIN 48 approaches, the staff commented that it expects quantified company-specific disclosures, rather than general dis-

closure such as, “the company is still evaluating the effect of FIN 48.”

## Revenue Recognition

### Revenue Recognition and Transfers of Financial Assets

In order to recognize revenue on the transfer of financial assets, the SEC staff observed that registrants must transfer accounts receivable. (See FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.) If a registrant has rights to future cash flows from a transaction that has not met the criteria for revenue recognition, then it would generally be inappropriate for the company to recognize revenue from the sale of those future cash flows (even if it makes the sale on a non-recourse basis). For example, Company A has not recognized revenue from the sale of its widgets because its customer, No Credit Co., has a low credit rating. Consequently, Company A should not recognize revenue from the sale of its receivable from No Credit Co. to an outside party.

The staff believes that the sale of financial assets that are not accounts receivable is a financing transaction that is like the sale of future revenues pursuant to EITF Issue No. 88-18, *Sales of Future Revenues*.

### Revenue Recognition Disclosures

A topic that frequently generates SEC staff comments is revenue recognition accounting policy disclosures. The staff commonly comments on the following topics and recommended that registrants:

- Revenue streams – Clearly identify each significant revenue stream and the related revenue recognition policy. Describe the company’s individual revenue

streams consistently in the financial statements, description of business, and MD&A.

- Multiple deliverables – Clearly describe each deliverable in multiple element arrangements.
- Deferred revenue – Explain why revenue is deferred and when the company expects to recognize it.
- Rebates, returns and allowances – Disclose how estimates of rebates, returns and allowances are made.

## Multiple Element Arrangements

The SEC staff discussed multiple element arrangements such as:

- Contract termination agreements;
- Executory contracts, including modifications to contracts that include upfront payments; and
- Litigation settlements that require future services or other concessions.

Since they do not involve revenue recognition, they are not subject to EITF Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*, and are not covered by specific authoritative literature.

The staff suggested the following analytic framework for such arrangements based on Issue 00-21 concepts:

- Consider whether the arrangement should be separated into two or more elements for accounting purposes – These arrangements are usually complex, and the accounting depends upon specific facts and circumstances. The staff believes that there is no one determinative factor in analyzing the arrangements but believes that registrants should consider whether:
  - The elements have independent economic value or substance;

- Any of the elements separately would meet the definition of an asset or liability;
- There are instances where similar elements would be purchased or sold on an individual basis; and
- The company has a reasonable basis to make an allocation among the elements.
- Consider how each of the elements should be measured – The SEC staff believes that fair value is a more appropriate allocation basis than the stated amounts in the contract.

## Share Based Payment

### Options Backdating

Several members of the SEC staff commented on stock based compensation and backdating issues. The comments with the broadest application to issuers follow:

- Sound corporate governance policies for grants of stock-based compensation, including procedures to ensure compliance with the law (e.g., Form 4 filing requirements), are important.
- Certain procedures that would have met the grant date requirements of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, may not satisfy the more detailed, comparable guidance in FASB Statement No. 123 (Revised 2004), *Share-Based Payment*. All corporate governance procedures must be completed in order to establish a grant date under current GAAP. Therefore, any delays that are encountered, either administrative or board approval when required, would delay the measurement of compensation cost.
- Backdated option exercise dates and related tax effects are a risk

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in addition to backdated grant dates.

- If errors resulting from backdated stock options are quantitatively immaterial, Staff Accounting Bulletin (SAB) No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, does not provide a “free pass” to cure such issues. Companies must also consider the qualitative effects of these errors in assessing materiality under SAB No. 99, *Materiality*.
- If the validity of a prior grant is in question, the registrant can account for the grant by relying on the substantive understanding between the company and its employees that reflects the underlying economics of the grant. The staff observed that this guidance does not invalidate the role of shareholder approval for certain grants (see question 19 of FIN No. 44, *Accounting for Certain Transactions Involving Stock Compensation*).

At the conference, the Chief Accountant of the Division of Corporation Finance (Corp Fin) indicated that the staff is drafting guidance for registrants that have multiyear restatements as a result of backdated stock options. The staff issued the letter on January 17, 2007 (<http://www.sec.gov/divisions/corpfin/guidance/oilgasltr012007.htm>). In the letter, the staff observes that if a registrant is filing its current year Form 10-K within two weeks of an amended Form 10-K that would otherwise be required, then the company can include the information required in its current year Form 10-K. If this does not fit the registrant’s timing, then the company should file the required information in an amended Form 10-K. This information includes:

- An explanatory note at the beginning of the amended Form 10-K

that explains the reason for the amendment.

- Selected Financial Data (Regulation S-K, Item 301) for the most recent five years, restated as necessary, with the columns labeled “restated;”
- MD&A (Regulation S-K, Item 303) based on the restated annual and quarterly financial information. Discussions that relate to interim periods can be incorporated into the annual-period discussion or presented separately;
- Audited financial statements for the most recent three years, restated as necessary, and with columns labeled “restated;”
- Interim period information for the most recent two fiscal years (Regulation S-K, Item 302), restated as necessary. Cash flow information is not required;
- Footnote disclosure reconciling previously filed quarterly and annual financial information to the restated financial information, on a line-by-line basis and for each material type of error separately, within and for the periods presented in the audited financial statements, the selected financial data, and the interim period information (Statement 154, paragraph 26);
- The disclosure required by the SEC Chief Accountant’s September 19, 2006 letter that applies to the restatement ([http://www.sec.gov/info/accountants/staffletters/fei\\_aicpa091906.htm](http://www.sec.gov/info/accountants/staffletters/fei_aicpa091906.htm));
- Audited financial statement footnote disclosure of the nature and amount of each material type of error separately that is included in the cumulative adjustment to opening retained earnings;
- Audited financial statement footnote disclosure of the restated stock compensation cost as follows:
  1. Restated net income and compensation cost and pro forma

disclosures for each annual period required by FASB Statement No. 123, *Accounting for Stock-Based Compensation*. Label the columns “restated,” as appropriate;

2. For each annual period preceding the most recent three years – The restated stock compensation cost that should have been reported for each fiscal year (see Statement 123, paragraph 45c2); the total of the restated stock-based compensation cost reconciled to the disclosure of the cumulative adjustment to opening retained earnings, including material tax adjustments related to the accounting for stock-based compensation by year; and, if the registrant chooses, the full restated information previously disclosed under Statement 123, paragraph 45c for each period prior to the most recent three years, either in the financial statement footnotes or elsewhere in the filing; and
- Appropriate revisions to disclosures regarding disclosure controls and internal control over financial reporting.

In the letter, the staff observes that the outlined guidance does not preclude further action or comment from Corp Fin or the Division of Enforcement.

### Special Classes of Stock Granted to Employees

The SEC staff commented on “special” types of stock based awards that are granted to employees as performance incentives. The staff provided two examples:

- An instrument tailored to the results of a particular operating division within a public company that the employee has responsibility for managing (e.g., an instru-

ment tailored to the results of a group of restaurants that the employee manages);

- An instrument linked to the appreciation realized through a future initial public offering or sale of the company for a company that is not yet public. These instruments have no or limited value if the IPO or sale does not occur.

The staff observed that the accounting issue is whether the awards are substantive equity or a performance/profit sharing arrangement. The attributes associated with each instrument are listed in the table below. (The staff discussed the above examples, but did not apply the model below to the two instruments.)

Awards that are determined to be equity should be accounted for under Statement 123(R) and measured and recognized at fair value. With respect to valuation, the staff believes an approach based on a *current liquidation* scenario would be inappropriate for a special class of stock whose value is driven primarily by *future* share price appreciation or profits. The staff also commented that the terms of these instruments often result in a requirement to classify the instruments outside of permanent equity (see EITF Topic D-98, *Classification and Measurement of Redeemable Securities*) and to present earnings per share using the two-class method (see EITF Issue No. 03-6, *Participating Securities and the Two-Class Method under FASB Statement No. 128*).

Awards that are determined to be performance bonus or profit sharing arrangements should be accounted for as liabilities and compensation expense, not as a return of capital or minority interest expense. If the employee made a payment for the arrangement at its outset, the payment should be reported as a deposit liability.

## Business Combinations

### Unfavorable Contracts for Sales of Products or Services

The SEC staff discussed contracts for sales of products or services that are acquired in a business combination transaction and how to assess and account for unfavorable contracts. If a contract reflects a lower price than what could be negotiated in a current market transaction, then the staff advised registrants to assess what events and circumstances had changed since contract inception to support a conclusion that the contract had become unfavorable. The staff believes that contract terms originally negotiated between the acquired entity and its customer represented a market rate of return at the date the contract was entered into. If circumstances have not changed, registrants should expect the staff to raise concerns about an assertion that an acquired contract was in an unfavorable position.

If the registrant can support that a contract is unfavorable, then it

should record a liability upon acquisition that allows the company to reflect a market rate of return for the acquired contract. The staff advised that the assumptions used to determine the current market rate of return for the 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 price. The staff bases this view on paragraph 37c of FASB Statement No. 141, *Business Combinations*, which provides guidance on assigning amounts to inventory acquired in a business combination.

### Customer Relationship Intangible Assets

The SEC staff continued last year's discussion of how to estimate the fair value of customer-related intangible assets in a business combination. Last year the staff expressed the view that the income approach is generally more appropriate than the cost method for valuing customer-related intangible assets. This year the staff clarified that it does not require the income approach, and that use of the income approach does not mean automatic staff acceptance of assumptions used in the valuation. The staff encouraged registrants to carefully assess the appropriate valuation method and to select the method that provides the best estimate of fair value.

The staff stressed that registrants should carefully assess the method for valuing customer relationship intangibles, and also should consider the factors that cause the acquired entity's customers to continue buying products or services. For products for which there are many market choices, this assessment may result in the identification and valuation of other intangibles such as brand names and

Equity Instrument	Performance Bonus or Profit Sharing Arrangement
<ul style="list-style-type: none"> <li>• Substantive voting rights</li> </ul>	<ul style="list-style-type: none"> <li>• Few if any assets underlie the special class</li> </ul>
<ul style="list-style-type: none"> <li>• Pari passu dividend rights</li> </ul>	<ul style="list-style-type: none"> <li>• The holder's claim to those assets is heavily subordinated</li> </ul>
<ul style="list-style-type: none"> <li>• Claims on the company's assets in liquidation</li> </ul>	<ul style="list-style-type: none"> <li>• Put or call rights that limit the employee's downside risk or provide for cash settlement</li> </ul>

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intellectual property. For example, customers may continue to buy the acquired product or service because of the brand name and technological superiority of the product in addition to the customer relationship. The company should consider and value all these identified intangibles, not just customer relationships, and the relative importance of these factors should be reflected in the valuation.

### Consolidation of Variable Interest Entities

Continuing to build on the 2005 and 2004 conference discussions of the identification of a variable interest entity (VIE), the SEC staff this year discussed the accounting by a registrant who is the general partner in a limited partnership that a registrant had initially identified as a VIE. The staff discussed this partnership structure as having the following attributes:

- The registrant general partner or GP makes no or only a non-substantive investment in the limited partnership or limited liability entity;
- The limited partners (LPs) have no kick-out rights (these are rights that support the LP's ability to dissolve the limited partnership or remove the GP without cause); and
- The registrant (GP) and at least one of the LPs are related parties as defined in paragraph 16 of FASB Interpretation (FIN) No. 46R, (December 2004) *Consolidation of Variable Interest Entities*, and paragraph 24 of FASB Statement No. 57, *Related Party Disclosures*.

The registrant considered the GP relationship with the partnership in isolation and concluded that:

- The partnership is a VIE because the holders of the equity investment at risk as a group do not have the ability to make decisions about the entity's activities that

have a significant effect on its success; and

- Since the GP does not absorb greater than 50% of the expected gains and losses, the GP is not a primary beneficiary and should not consolidate the VIE.

The staff suggested that the above analysis is incomplete because it does not consider the GP's relationship with the LP investors. If the relationship between the GP and one or more LPs is significant (based on facts and circumstances), the staff commented that the GP and related party LP interests should be considered in the aggregate. If the interests are considered together, the partnership passes the FIN 46R paragraph 5b(1) test that the GP and related party LP holders as a group have the ability to make decisions that affect the success of the entity. As a result, the entity would not be a VIE, and the accounting should be evaluated under the voting interest model.

The staff observed that the GP would be required to consolidate the limited partnership under the voting interest model of 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*. Issue 04-5 addresses the accounting treatment for investments by a GP in a limited partnership and establishes a framework to determine if the GP should consolidate a limited partnership that is not a VIE. The staff criticized partnership structures that were designed to circumvent the consolidation requirements of this issue.

## Fair Value Accounting

### Inception Gains

Last year, the SEC staff discussed the general challenges and benefits

presented by fair value accounting. This year the staff focused on a specific challenge, namely the implementation of FASB Statement No. 157, *Fair Value Measurements*. Statement 157 defines fair value as the exit price – the price an entity would receive in a sale of an asset or pay to transfer a liability. The Statement 157 definition of fair value:

- Eliminates the presumption in GAAP that the transaction price represents fair value; and
- Nullifies footnote 3 of 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*, which generally did not permit inception gains.

The staff observed that inception gains are not always appropriate despite the fact that the fair value at initial recognition is not limited to the transaction price. Under Statement 157, companies can record a day one gain for the difference between transaction price and model price, but this difference should be zero if the transaction occurred in the company's principal market. That is, the staff advised companies to calibrate valuation models for instruments traded in a company's principal market to match transaction price at inception.

The staff further observed that companies should use calibrated valuation models for subsequent valuations (also called day two valuations) based on Statement 157, footnote 18. This means that companies would only be able to record gains or losses based on actual changes in market conditions.

### Fair Value and Existing Guidance

Given the increasing use of fair value in financial reporting, the staff discussed management's responsibility for valuations. While management is not expected to be

expert in performing valuations and may hire a valuation specialist, management is still responsible for determining the approach and assumptions used by the specialist, and for ensuring that the approaches and assumptions are in accordance with GAAP.

The staff also addressed certain fair value accounting issues that exist in the “darker corners” of the current accounting literature. The staff cautioned that all applicable guidance must be considered in fair value accounting and provided several examples including the following example with multiple embedded derivatives related to a complex derivative instrument.

DIG Issue B15 requires that all the embedded features requiring separate accounting under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, must be bundled together and valued as a single compound derivative instrument. The staff observed that it has seen a number of instances in which companies inappropriately valued the instrument by simply adding the value of each of the embedded features together. The features of one embedded item can affect the valuation of other items, and consequently the interaction of the embedded features should be considered in reaching a value for the instrument as a whole.

### Accounting for Inventory at Fair Value

The SEC staff discussed the propriety of reporting inventory at fair value. The staff cited Chapter 4 (inventory pricing) of ARB 43, *Restatement and Revision of Accounting Research Bulletins*, as the relevant accounting literature for determining the measurement of inventory, and noted that only in exceptional cases should inventory be recorded at an amount in excess of its original cost. The staff observed that pre-

cious metals such as gold and silver qualify as exceptions and can be carried at monetary value because they:

- Are sold in an effective government-controlled market; and
- Have fixed monetary value with no substantial cost of marketing.

The staff noted that, excluding precious metals as discussed above, registrants must meet all of the following ARB 43 criteria to carry inventory over cost:

- An inability to determine approximate costs;
- Immediate marketability at quoted market prices; and
- The characteristic of unit interchangeability.

The staff believes that registrants can determine approximate inventory cost in most situations, including those involving commodity inventories, and consequently they do not meet the criteria in ARB 43 to carry inventory above cost. The staff observed that in today’s information-saturated environment, it would be rare that a registrant could support its inability to determine inventory cost.

Further, the staff noted that ARB 43 takes precedence over industry practices that permit measuring inventory at fair value. The EITF is currently considering whether entities within the scope of the AICPA Audit and Accounting Guide, *Brokers and Dealers in Securities*, should account for physical commodity inventories at fair value. The staff noted that the FASB would be required to amend ARB 43 before this position could become final.

## Financial Instruments – Derivatives

### Hedge Documentation

The SEC staff discussed the documentation required for hedge accounting. In order to qualify for

hedge accounting the documentation must include:

- A description of the hedged item and of the hedging instrument;
- A statement designating which type of hedge accounting is being followed (e.g., fair value, cash flow, or net investment in foreign operations);
- A statement of the intended hedge objective, including a discussion of the nature of the risk being hedged and any related hedge strategy or methodology;
- A discussion explaining how the hedging instrument’s effectiveness in offsetting the change in fair value or cash flows associated with the hedged risk will be assessed, both prospectively and retrospectively; and
- A discussion of the method that will be used to measure hedge ineffectiveness.

The staff observed that it has accepted a variety of approaches to hedge documentation as long as registrants have all the elements noted above. However, if the documentation is missing elements, hedge accounting may be inappropriate. The staff stressed that there are no bright lines for sufficient documentation. Consequently, registrants and their auditors must apply judgment to determine if the hedge documentation is appropriate.

Statement 133 allows a company to designate a group of individual transactions as the hedged item if those individual transactions share the same risk exposure. When the transactions share the same fundamental attributes, the shared risk exposure might be obvious. However, when transactions have differing characteristics (such as individual commodity sales with different delivery points), the company must document that the individual transactions have a sufficiently homogenous risk exposure

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to be included in a single hedging relationship. The staff further advised that the company may be required to periodically update its analysis throughout the life of the hedge if there are changes in the composition of the group of transactions.

### Shortcut Method

This year the SEC staff continued its 2005 discussion of the limited applicability of the “shortcut” method of assessing hedge effectiveness. The staff reiterated that this method is only available to hedges involving certain “straightforward” interest rate swaps and recognized interest-bearing assets and liabilities. Under the shortcut method, companies are permitted to assume no ineffectiveness in a hedging relationship, and do not have to perform on-going prospective and retrospective assessments of the effectiveness of the hedge. The shortcut method is only available to companies that meet all the general hedge requirements (e.g., contemporaneous formal documentation) of Statement 133 as well as all the criteria specific to shortcut method hedge accounting.

At the 2005 conference, the staff stressed that all the criteria in Statement 133 must be met to qualify for the shortcut method. The staff remarked that there is no “spirit” or “principle” to the shortcut method that can be met without satisfying all the criteria. This year the staff discussed two situations that did not meet the requirements for the shortcut method.

Trust preferred securities are debt instruments with features that typically allow the issuer to defer interest payments. Often, companies enter into interest rate swaps to hedge the exposure to changes in the future cash flows due to interest rate fluctuations, and these com-

panies sometimes elect to apply hedge accounting. The staff objects to the shortcut method when the debt contains interest deferral features, whether or not the interest rate swap contains a mirror image deferral option. The staff believes that the shortcut method can only be applied to “straightforward” instruments, and that debt with deferrable interest payments is not a “straightforward” instrument.

Many variable-rate debt instruments allow the borrower to prepay the debt at par on an interest rate reset date. Statement 133 generally precludes application of the shortcut method when the interest-bearing asset or liability is prepayable at other than fair value. Some companies have applied the shortcut method for such instruments, arguing that par value on an interest rate reset date is equal to fair value. The staff observed that par value is not equal to fair value if the interest rate is not adjusted for changes in the borrower’s creditworthiness or credit sector spreads. Consequently, the staff believes the shortcut method is not appropriate.

The staff emphasized that while application of the shortcut method is not appropriate in the above situations, hedge accounting might have been acceptable if justified by a full effectiveness assessment.

### Critical Terms Match Method

Companies that do not qualify for the shortcut method may be able to meet the requirements to use the critical terms match method which also assumes no ineffectiveness in a hedge relationship. The critical terms match method from paragraph 65 of Statement 133 is a long-haul, not a shortcut method, and registrants must perform and document periodic evaluations of the hedge relationship.

A company using the critical terms match method must periodically assess whether:

- The critical terms of the hedged item and the hedging derivative still match; and
- There has been a decline in the creditworthiness of one of the counterparties.

The SEC staff provided two examples of hedging relationships where the critical terms of the derivative instrument and the hedged item do not match, resulting in the need to measure and recognize hedge ineffectiveness:

- The two counterparties in a fair value hedge of an interest rate exposure using an interest rate swap differ in their creditworthiness; and
- The settlement dates of the forecasted transaction and the hedging derivative differed. Even a difference of just a few days is a difference in critical terms.

The staff reiterated that a company could still apply hedge accounting in these situations if a full assessment of hedge effectiveness supported such treatment. In fact, the staff noted that when a company had performed and documented an analysis demonstrating that the amounts of potential ineffectiveness would be insignificant, it had accepted the company not recording known amounts of ineffectiveness.

### Quantification of Errors

The SEC staff has frequently been asked how to quantify the effect when a company has inappropriately applied the shortcut method or assumed there is no ineffectiveness in a hedge relationship. Some registrants have argued that the error equals the amount of ineffectiveness that would have been recognized under the long-haul method. The staff does not agree

with this unless the company met the requirements for, and thus was eligible to use, the long-haul method (including periodic retrospective and prospective analysis of effectiveness). Consequently, the staff commented that if the company did not meet these requirements, the error should be quantified as the effect of applying hedge accounting.

### Classification of Warrants in a Registered Offering

In contrast to last year, the SEC staff's interpretive guidance of EITF Issue No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*, was relatively light. However, the staff did discuss one narrow issue on the appropriate classification of a warrant in a registered unit offering based on its interpretation of U.S. securities law.

To illustrate, assume a company issues a unit in a registered transaction that consists of a share of stock and a warrant to purchase an additional share of stock at a fixed price in the future. The warrant expires in three years. The staff believes securities law requires the warrant to be settled in registered shares since it was registered at inception. This is true even if:

- The warrant agreement states that exercise of the instrument can only occur if there is an effective registration statement at the time of exercise; or
- The registration statement or warrant agreement indicates that the warrant's value would be significantly affected by the investor's inability to exercise, perhaps resulting in a complete loss of value.

The staff believes that the contractual limitation on exercise when the company is unable to deliver registered shares merely replicates

legal requirements. Further, the limitation is intended to prevent the issuer from being contractually compelled to violate the securities law by issuing unregistered shares, and does not represent a viable alternative to settlement in registered shares. Consequently, if an effective registration statement is not in place when a holder exercises, the staff believes that cash settlement is assumed. To avoid liability classification for these instruments, the staff advised that the warrant agreement must explicitly state that:

- Nonperformance is a specific settlement alternative; and
- In no event will cash settlement be required.

Further analysis would be necessary under the remaining provisions of Issue 00-19 to determine whether the warrant otherwise qualifies for equity classification.

### Statements of Cash Flows

At last year's conference, the SEC staff observed that the statement of cash flows has been receiving increased focus by investors and analysts. The staff began and continues to subject the statement to greater scrutiny and to question classification. Registrants should make sure that cash flows are properly classified within the three major categories required by FASB Statement No. 95, *Statement of Cash Flows*: operating, investing and financing. This year the staff again cautioned registrants to exercise judgment regarding classification and to look to Statement 95 for guidance and examples. When Statement 95 does not offer specific guidance, registrants should consider the nature of the activity and the predominant source of the cash flows.

The staff discussed the classification of restricted cash, which is typically classified within investing cash flows. The staff believes these cash flows may be more appropriately classified as operating cash flows if the restricted cash clearly relates to the operating activities of the organization. For example, a public school that receives government grants that may be used only to fund school operations should classify the receipt and use of those restricted funds within operating cash flows.

The staff repeated its "assess, document, disclose" advice as applied to material cash flow classification judgments. When a registrant believes others might reasonably classify similar cash flows in a different manner, the staff believes the registrant should provide disclosure that describes the amounts involved, the classification chosen, alternative classifications considered and rejected, and the basis for selecting the classification ultimately chosen.

### Benefit Plans

#### Offsetting Benefit Plan Changes

The SEC staff has observed registrants that have entered into interrelated offsetting benefit plan transactions, decreasing benefits under certain arrangements such as annual bonuses and increasing benefits under pension and other postemployment benefit plans. If the fair value of both the increase and the decrease were recognized immediately in the income statement, there would be no income statement effect. However, if the transactions are viewed independently, the deferred recognition provisions of FASB Statements Nos. 87, *Employers' Accounting for Pensions*, and 106, *Employers' Accounting for Postre-*

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*tirement Benefits Other than Pensions*, result in the recognition of certain plan changes over future periods while the changes in annual bonus plans are recognized immediately in the income statement. Consequently, the result of such offsetting benefit plan changes is reduced expense and increased net income in the period of the transactions.

For example, a company may negotiate with its employees to exchange an earned and presently due bonus for an equal increase in the benefits payable under its pension plan. If the two changes were considered individually, the elimination of the bonus accrual would be reflected as an immediate reduction in expense in the income statement, while the benefit enhancement in the pension plan would be reflected as prior service cost and recognized as expense over future years. The SEC staff believes that this accounting does not reflect either GAAP or the underlying economic substance of the offsetting benefits transaction.

The staff believes that concurrently negotiated changes in various benefits plans should be accounted for together rather than separately. The staff bases this approach on the FASB Staff Implementation Guides to Statements 87, 88 and 106. This guidance directs that in some circumstances, it may be most appropriate to immediately recognize in income part or all of the change in the obligation under a defined benefit plan rather than reflecting such change as a plan amendment that is amortized into income over future periods. If the reduction in expense for the decrease in bonuses is recognized at the same time as the increase in the obligation in the current period, the registrant would appropriately

recognize the two transactions as one and report them in the current period income statement. If the two benefit changes are reported in this manner, registrants would *not* report increased net income as a result of the offsetting transactions.

### Defined Benefit Plan Changes

The SEC staff discussed registrants that reduced or eliminated defined benefit plans such as pension plans in exchange for the creation of fixed contribution plans. The staff noted that Statements 87 and 106 are clear that a plan is a defined contribution plan only if it:

- Provides benefits in return for services rendered;
- Provides *an individual account* for each participant; and
- Has terms that specify how contributions to the accounts of individuals are to be determined rather than the amount of benefits to be received.

The staff observed that it has seen plans that don't meet these criteria and specifically discussed plans that lacked individual accounts for each participant. Even if the employer is liable to the plan for only the amount of the total fixed contribution, these plans are not defined contribution plans. Consequently, the staff believes that these plans should be accounted for as defined benefit plans.

## Executive Compensation Disclosure Rules

John White, the Director of Corp Fin, and Carol Stacey, the Chief Accountant of Corp Fin, both discussed the new executive compensation disclosure rules that became effective for Forms 10-K and 10-KSB for fis-

cal years ending on or after December 15, 2006.<sup>1</sup> This means that calendar year end filers are required to make the new disclosure in their annual reports for 2006. The purpose of the new rules is not to regulate the type or level of compensation, but to inform investors about all components of executive and director compensation.

Mr. White provided an overview of the requirements of the new rules, including:

- A Summary Compensation Table (SCT) that includes a new total compensation amount;
- The named executive officers included in the table are defined to include the Principal Executive Officer, Principal Financial Officer, and the three other most highly paid executives;
- Compensation Discussion and Analysis (CD&A), the MD&A-like discussion of executive compensation policy and decisions. The CEO and CFO Section 302 Sarbanes-Oxley certifications cover this information;
- A compensation committee report certifying that the compensation committee has reviewed the CD&A and approved that the CD&A be included in the registrant's annual report over the committee member names. This report is furnished rather than filed, resulting in a lower level of legal liability;
- The Grants of Plan-Based Awards Table, a table that supplements the SCT and includes both cash and equity awards. The rules require that a narrative disclosure accompany this table and the SCT to provide context and explanations for the information in the tables;
- Tables for Outstanding Equity Awards at Fiscal Year-End and for

<sup>1</sup> For further background regarding the new executive compensation disclosure rules, see our *Financial Reporting* letter, *Executive and Director Compensation Disclosure Rules*, available at <http://www.bdo.com/about/publications/assurance/FRLExecComp-9-06-3.pdf>.

Option Exercises and Stock Vested during the fiscal year;

- Tables for Pension Benefits and for Nonqualified Deferred Compensation and narrative disclosures for other postemployment payments payable at termination or change in control; and
- A Director Compensation Table.

Mr. White focused on the CD&A, what he termed the “heart” of the new disclosure rules. Mr. White said that he wished he had enough inspirational power as a speaker to inspire his listeners to draft meaningful CD&As. In the new CD&A, registrants are required to analyze and discuss material factors underlying compensation policies and decisions. CD&A is a company report, not a compensation committee report. It must discuss compensation awarded to the executives in plain English. It provides context for the disclosure and the numbers in the executive compensation tables.

After the conference, on December 22, 2006, the SEC revised its rules to require registrants to report option and stock awards costs over the requisite service period in the SCT and Director Compensation Table, similar to the manner in which they are reported under Statement 123(R). The previous rules required the entire grant date fair value of option and stock awards to be reflected in the SCT and Director Compensation Table in the year of the grant, regardless of the extent to which the award had vested. For example, under the revised rules, if a named executive officer receives an option grant with a fair value of \$25 million with a 5-year cliff vesting, the amount reported in the SCT under option awards for each year of the vesting period would be \$5 million.

The revised rules still require disclosure of the entire grant date fair value of an award, but in a different location. The SEC amended the Grants of Plan-Based Awards Table to add a column showing the entire grant date fair value of each equity award (grant by grant) computed in accordance with Statement 123(R). In the above example, the amount reported in the Grants of Plan-Based Awards Table in the year of the grant would be \$25 million. For directors, the complete grant date fair value of each equity award granted during the year is now required to be reported in a footnote to the Director Compensation Table.

### Form 8-K and Restatement Reporting

The SEC staff discussed financial statement restatements and the SEC requirement to file an Item 4.02 Form 8-K. The staff referred to the General Accounting Office’s July 24, 2006 report on restatements (<http://www.gao.gov/new.items/d06678.pdf>). This report observed that a number of companies notified investors of their restatements in their Forms 10-Q or 10-K rather than filing a report under Item 4.02 of Form 8-K. The report recommended that the SEC clarify its rules regarding the requirement to file a Form 8-K to notify investors about a financial statement restatement.

At the conference, the staff discussed the registrant’s process for evaluating an error and possible restatement. If the registrant determines that its previously issued financial statements can no longer be relied upon because of errors or its auditor advises that the previously issued audit report or completed interim review should no

longer be relied on, the company must file a Form 8-K within four business days. If the registrant determines that an error and an associated restatement are not material (and that a Form 8-K filing is therefore not necessary), the staff advised that the company should be prepared to support its conclusion. Also, the staff may question the timing of the Form 8-K if it is filed shortly before an amended Form 10-K or 10-Q filing. Given the time it usually takes to prepare restated financial statements, this suggests that the Form 8-K may not have been filed within four business days of the date the registrant concluded the financial statement should not be relied upon.

The staff observed that registrants are always required to file Item 4.02 Form 8-Ks when prior financial statement should not be relied upon. The staff quoted its Frequently Asked Questions document (<http://www.sec.gov/divisions/corpfin/form8kfaq.htm>). 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.”

### Management’s Discussion and Analysis of Financial Condition and Results of Operations (MD&A)

Since the Commission released interpretive guidance on MD&A<sup>2</sup> in December 2003, the SEC staff has observed that it has seen improvements in MD&A such as more use

<sup>2</sup> Release 33-8350, *Commission Guidance Regarding Management’s Discussion and Analysis of Financial Condition and Results of Operations*.

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of executive summaries and increased presentation of tables, charts and graphs to supplement narrative disclosure. However, the staff commented that it still sees room for improvement, particularly in analysis of results of operations, critical accounting estimates, and liquidity.

*Analysis of results of operations* – The staff believes that MD&A often falls short on disclosure that explains the “why” behind the numbers. MD&A should provide a context in which an investor can understand the company’s results. It should bridge the gap between the financial statements prepared in accordance with GAAP and the economic realities of a company’s operations. It should clearly explain the substance of transactions disclosed in the footnotes. In addition, the analysis should explicitly identify known trends associated with important events and whether or not management believes these trends will continue.

*Critical accounting estimates* – The staff believes that many issuers have ignored the guidance regarding disclosure of critical accounting estimates that was contained in Release 33-8090, *Disclosures in Management’s Discussion and Analysis about the Application of Critical Accounting Policies*. These disclosures should communicate uncertainties and how they might affect the financial statements. The staff commented that repeating disclosure from the accounting policies footnote does not satisfy the MD&A requirements to disclose known uncertainties that are reasonably likely to materially affect future operating results.

Critical accounting estimates disclosure should focus on numbers in the financial statements that are sensitive to material change from external factors. The disclosure should provide insight into:

- The assumptions used in deriving estimates, particularly those that factor into fair value estimations;
- How the estimate was arrived at, including all assumptions that factored into the initial estimate, and how susceptible the estimate is to variability;
- If any of the assumptions have changed from the prior period, the reason for the change and resulting impact on the estimate; and
- Factors that could cause the estimate to change in the future and the potential magnitude of future changes.

The discussion should be limited to those estimates that are most critical. Examples of critical accounting estimates that should be discussed in MD&A include material items recorded at fair value, impairment of long-lived assets and goodwill, pension and other post-retirement benefit costs, and loss contingencies.

*Liquidity* – The liquidity section of MD&A should focus on known trends and uncertainties that are reasonably likely to materially affect liquidity. Management should not simply recite the cash flows statement line by line, but should provide meaningful analysis of why liquidity changed, not just how much it changed. For example, if accounts receivable have decreased from the prior year, the liquidity discussion should address:

- Was the decrease due to improved collections or a decrease in revenue?
- Was there a change in credit terms that affected collections?
- Were receivables factored or securitized during the current or prior year?
- What is the likelihood that the circumstances and events causing the current year decrease in receivables will continue in the future?

Company borrowings and other material obligations and access to financing are a key component of liquidity. With regard to material obligations and new borrowings, the discussion should answer questions such as the following:

- What are the payment due dates?
- How does the company intend to satisfy its obligations (e.g., with current cash on hand and operating cash flows or with new borrowings)?
- Are new borrowings a key component in satisfying current demands?
- If so, are there specific plans for obtaining such borrowings?
- Does management foresee any difficulties in accessing additional financing?

Disclosure of off-balance sheet arrangements is another key component of liquidity. Management should discuss the magnitude and importance of off-balance arrangements that are reasonably likely to affect liquidity, including material losses and obligations that could result from such arrangements.

The table of contractual obligations supplements the discussion of liquidity. The “Other Long-term Liabilities” line of the table should include all material long-term obligations not reported on the first three lines of the table, whether or not disclosed elsewhere in the filing. Examples of items to disclose on this line include material pension or other post-retirement benefit funding obligations and income or other material tax obligations. Management should use its judgment in deciding how to present the timing of payments reported for these items. The staff encourages the use of footnotes to supplement the disclosures in the table.

Finally, the staff discussed MD&A liquidity disclosures related to the recently enacted Pension Protec-

tion Act of 2006, which strengthens the funding requirements for certain types of pension benefit plans. Registrants should provide transparent disclosure of the Act's anticipated impact on the company's liquidity and capital resources. Although in some circumstances it will be difficult to forecast precise funding requirements, the staff believes it will often be possible to provide disclosure of the magnitude of future cash commitments assuming present market conditions remain constant.

## Non-GAAP Financial Measures

The SEC staff observed that it had seen instances of full non-GAAP income statements. These statements are typically structured as follows:

1. The first column reflects a GAAP income statement;
2. The second column contains various adjustments; and
3. The third column combines the first two columns to arrive at a non-GAAP income statement.

The staff has objected to these presentations, both in filings and earnings releases, and required registrants to amend filings to remove such presentations. The staff objects because it believes:

- These presentations inappropriately imply that they are on a comprehensive basis of accounting (but they are not); and
- They rarely provide the disclosures that explain the reasons why management believes that presentation of the multiple non-GAAP financial measures reflected in such statements provides useful information to investors.

Consequently, the staff believes such presentations do not comply with the requirements of Regulation G or Item 10(e) of Regulation S-K.

## Pro Formas and Forecasts

The SEC staff reminded registrants that it is inappropriate to include in pro forma information adjustments that contain elements of a forecast. The Regulation S-X, Article 11 rules restrict pro forma income statement adjustments to entries that are:

- Directly attributable to the transaction;
- Factually supportable; and
- Expected to have a continuing impact.

The staff noted that pro forma financial information should illustrate only the isolated and objectively measurable effects of a particular transaction. Pro forma financial information should exclude effects that rely on judgmental estimates of how historical management practices and operating decisions may or may not have changed as a result of a business purchase transaction.

The staff pointed out that information about the possible or expected impact of current actions taken by management in response to the transaction is considered a projection. The staff noted that the presentation of forward looking and projected information should be confined to supplemental information separately identified as forecast and not as Article 11 pro forma information.

## SAB 108

The SEC staff discussed SAB 108 and the approach it believes registrants should use to quantify the misstatement of current year financial statements that results from misstatements of prior year financial statements. The SAB was issued in September and requires issuers to use both of the two approaches

(iron curtain and rollover) currently used to assess the materiality of errors. It requires issuers to adjust their financial statements if the either approach results in a conclusion that an error is material.

To evaluate whether financial statements are materially misstated, issuers and auditors typically follow a two-step process. They (1) identify and quantify misstatements that have not been corrected and (2) evaluate whether the effects of those misstatements are material. SAB 99 (Topic 1M) provides guidance for performing the second step in the process. In assessing materiality under SAB 99, registrants must also consider the qualitative effects of these errors.

The staff discussed whether large errors could be immaterial, and concluded that it is only possible if the registrant were able to support that its financial statements were reliable *notwithstanding* the large error. The staff observed that it could hypothesize only two very limited circumstances in which this might occur – errors in break-even years and in discontinued operations. The staff cautioned that registrants should consider all relevant factors in reaching a judgment on materiality and should have compelling support for their conclusions.

The staff also discussed whether an individual error could be immaterial simply because of the existence of an offsetting error of equal magnitude. While the staff believes that registrants must evaluate each error individually, no matter what its effect when combined with other errors, practice is inconsistent. Companies should assess all relevant qualitative and quantitative factors and consider errors on an individual and aggregate basis.

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### International Reporting Issues

Julie Erhardt, Deputy Chief Accountant for international matters, discussed the SEC's action plan for convergence between International Financial Reporting Standards (IFRS) and U.S. accounting standards. Based on the action plan for convergence (also known as the "roadmap"), IFRS could coexist without reconciliation to U.S. GAAP in the U.S. capital markets by 2009. Ms. Erhardt noted that an early mile marker in the roadmap has not been reached. That marker is the anticipated shift in the number of registrants filing "home country" financial statements prepared pursuant to IFRS. The staff expected the number of IFRS filers to increase from 40 in 2004 to 300 in 2005. However, the staff observed that the number of IFRS filers stayed static at 40 in 2005.

The staff of Corp Fin noted that its reviewers and the review process for foreign private issuers are the same as that used for domestic filers. In accordance with Sarbanes-Oxley Act, the staff reviews all registrants, including foreign private issuers, at least once every three years.

The staff discussed issues that it identified in financial statements prepared on the basis of IFRS or jurisdictional adaptation of IFRS in 2005, the first year that many European companies were required to implement IFRS in their primary financial statements. The staff identified two big picture issues – presentation and disclosure, and observed that it is too early in the reviews to identify issues regarding the application of IFRS accounting.

- Presentation – The staff observed that certain required information and footnotes were located outside the financial statements portion of the filing, and advised registrants to consider an overall layout for 2006 that is transpar-

ent and understandable. Also, the staff commented that it continues to have questions about the nature of accounts labeled as "operating income."

- Disclosure – The staff commented on disclosures that were omitted, lacking in clarity, and lacking in depth. For example, information omitted included the number of authorized shares; events and circumstances that cause recognition of an impairment loss; the method used to calculate the impairment loss; and description of the method of accounting for consolidated and equity method investments. Information lacking in depth included revenue recognition criteria taken directly from IAS No. 18, *Revenue*, and listed as the registrant's revenue recognition policy.

### Internal Control over Financial Reporting

At the conference, the SEC staff addressed the upcoming release of the Commission's proposed interpretive guidance regarding management's assessment of internal control over financial reporting (ICFR). The SEC discussed the proposal at an open meeting on December 13, and the proposal clarifies that companies performing evaluations of ICFR in accordance with the guidance would meet the ICFR evaluation required by SEC rules. Also, the SEC proposed amendments to Regulation S-X that clarify the auditor's reporting requirement pursuant to Section 404(b) of the Sarbanes-Oxley Act. The SEC issued the proposed guidance on December 20, 2006, and it can be found at [www.sec.gov/spotlight/soxcomp.htm](http://www.sec.gov/spotlight/soxcomp.htm).

The staff observed that the number of companies reporting material weaknesses has decreased, but

the type of material weaknesses being reported are typically the cause of restatements (e.g., revenue recognition, income taxes, and estimates and significant liabilities). When a restatement occurs, financial statement users and the staff generally assume that ICFR was ineffective. The staff commented that management's evaluation should be sufficiently robust and should focus on the areas of highest risk, including estimates and complex accounting issues.

The staff voiced its concern that registrants were not reporting material weaknesses involving controls over fraud risk. Two resources discussed for robust fraud risk assessments were:

- COSO guidance for smaller public companies, available for a fee at: <http://www.coso.org/publications.htm>; and
- *Management Override of Internal Controls; The Achilles Heel of Fraud Prevention* available on the AICPA website at [http://www.aicpa.org/audcommctr/download/achilles\\_heel.pdf](http://www.aicpa.org/audcommctr/download/achilles_heel.pdf)

### PCAOB Matters

The PCAOB staff spoke about the Board's upcoming release of a proposed new auditing standard on internal control that would supersede the current standard on the topic, AS No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of the Financial Statements*. The Board has assessed the implementation of AS 2 over the last two years and is proposing a new standard in an effort to increase efficiencies while maintaining the effectiveness of an ICFR audit. The staff outlined the objectives of the new standard:

- Focus the audit on the matters most important to internal control;

- Eliminate unnecessary procedures;
- Scale the audit for smaller companies; and
- Simplify the requirements.

The PCAOB released the proposed new standard, *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of the Financial Statements*, on December 19, 2006. The proposed guidance has integrated the *Staff Questions and Answers – Auditing Internal Control Over Financial Reporting*, clarified the definitions of a material weakness and significant deficiency, expanded the potential for use of the work of others, and expanded the consideration of the results of prior year testing as part of the current year risk assessment. Also, the proposed standard clarifies the extent of the auditor's work with respect to management's assessment.

On December 19, 2006, the PCAOB also proposed a new audit-

ing standard on using the work of others, a new independence rule on non-audit services related to internal control, and certain related amendments to the PCAOB's interim auditing standards. The proposals can be found at [www.pcaobus.org/Standards/Proposed\\_Standards\\_and\\_Related\\_Rules.aspx](http://www.pcaobus.org/Standards/Proposed_Standards_and_Related_Rules.aspx).

### XBRL Reporting Program

In 2005, the SEC established a voluntary program for issuers to file information in Extensible Business Reporting Language (XBRL). XBRL tags data based on taxonomies that categorize the financial statement information. In September 2006, the SEC announced a \$54 million initiative to transform its EDGAR database from a form-based search tool to an interactive tool based on XBRL. At the conference, several speakers either commented on their

positive experiences with XBRL or answered questions about related rule making, standard setting, and regulatory initiatives.

### For Further Information

If you would like further information or to discuss the implications of these matters, please contact the BDO Seidman, LLP engagement partner serving you or one of the following partners:

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