

**BDO Seidman, LLP**  
Accountants and Consultants



# Financial Reporting

**Conference Themes..... 1**

**Accounting Matters .....2**

- Litigation Settlements .....2
- Change from Consolidation to Equity
  - Method .....3
- Business Combinations – Identifying the
  - Acquiring Entity .....3
- Financial Instruments.....3
  - Other-Than-Temporary Impairment .....3
  - Loans Receivable Classification .....4
  - Equity Derivatives .....4
- Guarantees .....4
- Fair Value Accounting.....5
  - Valuation of Share-Based Payment
    - Arrangements .....5
  - Market Instruments Used to Measure
    - Employee Share-Based Payments .....5
  - Replacement Cost and the Valuation of
    - Acquired “Scarce” Intangible Assets .....5
  - Fair Value Election .....6
- Revenue Recognition.....6
  - Software Revenue.....6
  - Multiple Deliverables and Joint Steering
    - Committees .....7
- Errors .....7
- Judgment and the Review Process.....8

**SEC Rules and Regulations Issues....8**

- Experts and Consents.....8
- MD&A .....8
  - Fair Value Measurements.....9
  - Pro Forma Information .....9
  - Off-Balance Sheet Arrangements.....9
- Product and Service Revenue Presentation.10
- Form 8-K Item 4.02 .....10

**International Reporting Issues.....10**

**Internal Control Reporting .....11**

- Guidance for Management .....11
- Newly Acquired Companies .....12

**For Further Information.....12**

## Report on the AICPA SEC and PCAOB Conference

The 2007 annual AICPA National Conference on Current SEC and PCAOB Developments was held in Washington, D.C. in December. The speakers focused at length on the future of financial reporting in the United States as well as the traditional focus on practice issues arising from complex accounting and reporting matters. This discussion of the future of financial reporting covered the progress made over the past year in addressing issues discussed extensively at prior conferences, including reducing complexity, converging accounting standards and using interactive data. The remarks of SEC Commissioner Kathleen Casey, members 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/2007speech.shtml#2fourthq>.

### Conference Themes

At this year’s conference, the presentations covered such topics as the use of judgment, complexity, International Financial Reporting Standards, the goal of achieving one set of global accounting standards, internal control over financial reporting, and XBRL.

Throughout the conference, the SEC staff’s remarks set a tone of respect for well-reasoned judgments made by registrants and their auditors. The staff emphasized that registrants that support accounting conclusions with sound reasoning would have their judgment respected by the staff. The staff also

## Financial Reporting

discussed the steps registrants should take to increase their confidence in their accounting conclusions:

- Make sure to have a complete understanding of the transaction or arrangement;
- Involve those with adequate knowledge and experience up front;
- Realize that there may not always be one "right" answer; and
- Provide transparent disclosure.

Speakers also discussed the challenges auditors and preparers face as a result of the complexity of the current financial reporting system. They commended the work of the SEC's Advisory Committee on Improvements to Financial Reporting (or CIFI<sup>R</sup>) on recommending ways to reduce complexity. CIFI<sup>R</sup> released a document for public exposure with tentative conclusions in January 2008 and intends to begin issuing recommendations in the spring.

Several speakers focused on the progress being made toward the use of IFRS as a single set of high quality accounting standards by companies around the globe. They also expressed the hope that convergence between U.S. GAAP and the more principles-based IFRS would reduce complexity. They discussed the infrastructure that is now in place that makes possible the acceptance of foreign private issuer IFRS financial statements without a reconciliation to U.S. GAAP and outlined possible strategies for preparing to allow domestic registrants to file IFRS financial statements.

Speakers also highlighted the more principles-based approach to auditing internal control reflected in Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and the

SEC's guidance on management reporting on ICFR. Commissioner Casey urged "companies and their auditors to exercise judgment in assessing the appropriateness of internal control systems, in light of the nature and extent of particular business operations, and to focus on the areas of greatest risk."

A number of speakers discussed the promise of interactive data to promote consistency and analysis in financial reporting. In the fourth quarter, an XBRL taxonomy was released for review by users, and the SEC established the Office of Interactive Disclosure. The staff is evaluating this taxonomy prior to recommending to the Commission rulemaking that would require XBRL reporting by public companies. Also, the staff observed that the U.S. GAAP and IFRS taxonomy teams are working to ensure that the two taxonomies are aligned.

## Accounting Matters

The SEC staff also discussed its views on technical accounting matters that it believes are particularly relevant this year or give rise to frequent practice problems. Focusing on these types of matters has historically been the primary purpose of the conference and focus of the staff's speeches, although in prior years the speeches sometimes seemed to establish new GAAP. At the 2007 conference, the staff emphasized that its comments should not be construed as new GAAP and in many cases focused on factors that should be considered in making professional judgments. The following topics were among those discussed by the staff.

### Litigation Settlements

The SEC staff discussed accounting issues associated with litigation

settlements that contain multiple elements. While the accounting for litigation contingencies is within the scope of FASB Statement No. 5, *Accounting for Contingencies*, the accounting for complicated settlements that involve multiple elements is not straightforward. The staff provided an analysis of the settlement in the following example. A registrant pays cash and conveys licenses to a plaintiff to settle a patent infringement and misappropriation of trade secrets claim. In return, the registrant receives a promise to drop the patent infringement lawsuit, a covenant not to sue regarding the misappropriation of trade secrets claim, and a license to use the patents.

The staff observed that registrants should identify each item (e.g., asset, liability, revenue, and expense) given and received in the settlement to determine whether the items should be recognized. Items should be recognized only if they meet the appropriate GAAP definition. For example, if trade secrets could be obtained by legal means in the marketplace or if the specific trade secrets are not identified in the covenant not to sue, then the covenant may not meet the definition of an asset.

The staff commented that registrants may find it difficult to allocate consideration among elements in the settlement. While EITF Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*, was written for multiple element revenue arrangements, the staff observed that it can be used by analogy for allocating expenses. Therefore it may be appropriate to base the allocation on the relative fair value of the elements of the settlement. The staff also believes that the residual method can be used to value an element in a settlement if that element could not be otherwise valued and registrants can use rea-

soned judgment in estimating the fair values.

The staff discussed classification of the settlement and observed that if the registrant had no prior relationship with the plaintiff, the settlement should be classified in operating expense. However, if the registrant settles with a customer, the staff recommended that registrants refer to the guidance in EITF Issue No. 01-9, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)*, and consider reducing revenue for the settlement portion associated with the customer relationship. If the registrant receives an identifiable benefit with a measurable fair value, the amount of that benefit can be recorded as an expense, rather than a reduction of revenue. For the accounting by the customer, the staff referred to EITF Issue No. 02-16, *Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor*, that may require presentation of the settlement as a reduction of cost of goods sold.

### Change from Consolidation to Equity Method

The SEC staff discussed the proper financial statement presentation of an investment when changes in ownership result in deconsolidation and equity method presentation, for example, when a registrant sells 60% of its wholly-owned subsidiary to an unrelated party. Although such a change would be accounted for prospectively, the staff's longstanding position, supported by guidance included in ARB No. 51, *Consolidated Financial Statements*, was to not object to retroactive financial statement presentation, i.e., deconsolidation and equity method treatment of the investment from the beginning

of the fiscal year in which the change occurred.

However, with the effectiveness of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, the staff determined that its longstanding position is no longer consistent with GAAP. Statement 144 deleted paragraph 12 of ARB 51, which was the basis for the staff's position. Consequently, the staff no longer accepts retroactive application of equity method presentation to the beginning of the year of the ownership change. Registrants should now consolidate the investment up to the deconsolidation effective date and from that point forward the investment should be presented using the equity method.

### Business Combinations – Identifying the Acquiring Entity

In a business combination effected through an exchange of equity interests, the acquirer is generally the entity that issues the equity interests as discussed in paragraph 17 of FASB Statement No. 141, *Business Combinations*. However, paragraph 17 also requires all pertinent facts and circumstances to be considered in identifying the acquirer, including the composition of the governing body of the combined entity. Paragraph 17c states that the acquirer usually is the combining entity whose owners or governing body have the ability to elect or appoint a majority of the governing body of the combined entity.

In evaluating this requirement, registrants should consider how long each board member is entitled to hold his/her position, particularly when the combined entity's board is dominated by members who represent the minority shareholders' interests. The registrant's objective is to determine

whether control of the board is temporary or substantive. The SEC staff dismissed the notion that it uses a bright line to perform this evaluation, and observed that it is willing to accept a conclusion that a minority shareholder group controls the board without regard to a specified time period as long as the control is substantive. The staff emphasized that that registrant judgment is required in applying the requirements of paragraph 17c.

## Financial Instruments

### Other-Than-Temporary Impairment

Under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and SAB No. 59, *Accounting for Noncurrent Marketable Equity Securities*, registrants must recognize in earnings an impairment in the value of a security classified as available-for-sale or held-to-maturity if the fair value of the security is below its cost and the decline is "other-than-temporary" (OTT). The SEC staff addressed the importance of judgment in determining whether a decline in the value of a debt security that is unrelated to instrument-specific credit quality or an equity security is other-than-temporary.

Management's intent and ability to hold a security until an anticipated recovery in value is one of the determinative factors cited in SAB 59. The staff provided the following guidance related to this factor:

- *Ability to hold a security* – The staff believes that the inability to hold a security to recovery, perhaps as a result of liquidity and capital needs, indicates that an OTT impairment exists regardless of the severity and duration of the market decline.
- *Intent to hold a security* – The staff believes management must

## Financial Reporting

make a positive assertion of its intent to hold a security until recovery to conclude that a decline is temporary.

- *Anticipated recovery period* – The staff believes all available information, positive and negative, should be considered in estimating the amount of time required for the fair value of a security to recover to its historical cost. Information to consider includes:
  - the severity and duration of the impairment;
  - the historical and implied volatility of the security and changes in the fair value subsequent to the balance sheet date;
  - the financial condition and near-term prospects of the issuer of the security; and
  - whether the decline stems from macroeconomic factors or from specific information related to the individual security.

The staff did not provide a bright line definition of an anticipated recovery period, but did comment that the longer the forecasted recovery period, the greater the uncertainty, and the greater the need for more persuasive evidence to conclude that the impairment is temporary.

### Loans Receivable Classification

The SEC staff discussed issues related to the classification of loans receivable as held-for-investment or as held-for-sale as required by FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, and AICPA Statement of Position No. 01-6, *Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others*. Loans that management has the ability and intent to hold for the

foreseeable future or until maturity are classified as held-for-investment and carried at amortized cost less any allowance for loan losses. Other loans are classified as held-for-sale and are carried at the lower of cost or fair value.

The classification of loans receivable has a significant effect on measurement and presentation of the nature of the related cash flows in the financial statements. The staff believes that registrants should make positive assertions about their ability and intent to hold loans receivable and should classify the loans accordingly. Classifications approaches that lack positive assertions are generally inappropriate.

The staff noted that registrants should use judgment to define “foreseeable future” in a manner that is reasonable under the specific facts and circumstances. Some relevant factors that registrants should consider include the following:

- The entity’s business strategy and current business plans;
- The nature and type of the loan, including its expected life;
- The entity’s current financial condition and liquidity demands;
- The current economic environment and related market conditions; and
- The entity’s past practices.

If there are significant changes in relevant factors, a registrant’s definition of “foreseeable future” might change. The staff cautioned that registrants should carefully consider whether a reclassification of loans receivable that occurs at the same time as a change in definition is appropriate. Registrants that decide that the reclassification is appropriate should provide sufficient and transparent disclosure of the change in the financial statements.

Registrants should adopt an accounting policy on the level (i.e., individual or homogenous group) at which loans receivable are classified. The staff advised that the accounting policy selected should be appropriate given the facts and circumstances and should be disclosed in the financial statements along with the effect of the policy on the financial statements.

### Equity Derivatives

The SEC staff discussed the analysis necessary to determine whether equity derivatives are classified as equity or liabilities, and reminded registrants to consider the effects of all International Swaps and Derivatives Association (ISDA) agreement provisions included in derivatives contracts in making this determination. The ISDA agreements can be voluminous and complex, and the specific ISDA provisions that are incorporated into a derivative contract can vary from instrument to instrument.

The staff commented that certain ISDA agreements include provisions that allow the counterparty to net-cash settle an equity derivative contract upon events outside the issuer’s control. Under EITF Issue No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock*, paragraphs 7 to 11, contracts that require net cash settlement must be classified as liabilities. Consequently, only if the registrant’s contract includes an override to this ISDA provision that allows it to share settle the contract upon events outside its control, would the registrant be able to account for the derivative as equity.

### Guarantees

The SEC staff addressed the recognition of a guarantee issued by a parent to a wholly-owned sub-

subsidiary that is subsequently spun off. While FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, requires recognition and measurement of guarantees, it provides a scope exception for guarantees issued by a parent to a wholly-owned subsidiary. Consequently, before a spin-off, a parent would not recognize the guarantee made on behalf of its wholly-owned subsidiary. However, the staff observed that once the parent-subsidiary relationship ceases, the former parent should recognize the fair value of any guarantee of the former subsidiary's obligations that it retains.

### Fair Value Accounting

#### Valuation of Share-Based Payment Arrangements

Although FASB Statement No. 123R, *Share-Based Payment*, was scoped out of FASB Statement No. 157, *Fair Value Measurements*, the staff observed that fair value concepts such as market participant assumptions are used to value share-based payments. For example, registrants may restrict the transfer or sale of share-based payment grants. If a security has such a restriction that continues after the requisite service period, that post-vesting restriction may be factored into the valuation as a reduction in the security value. The amount of any such discount should be specific to the security, not based on a "rule of thumb" such as a flat 10%.

#### Market Instruments Used to Measure Employee Share-Based Payments

Under Statement 123R, registrants generally develop the grant date fair value of share-based payments using a pricing model such as Black-Scholes-Merton. Statement

123R states "that observable market prices of identical or similar equity and liability instruments in active markets are the best evidence of fair value and, if available, should be used as the basis for measuring share-based payment transactions," and registrants have expressed interest in market instruments that could be used to value these payments. Zions Bancorporation is developing a business in selling such instruments (known as an Employee Stock Option Appreciation Rights Security or ESOARS) and recently gained SEC staff approval of the design of its instrument.

Before approving the ESOARS, the staff considered instruments that would meet the measurement objective of Statement 123R. At the conference, the staff discussed its conclusions on the economic biases of two such instruments.

- Layoff instruments lay off an employer's obligation related to share-based payment to a third party. Since investors in these instruments are motivated to demand as much compensation as possible to assume the obligation, the instrument has an upward pricing bias.
- Tracking instruments track the payout to recipients of a share-based payment. Since investors in these instruments are motivated to pay as little as possible to obtain the right to future payouts, the instrument has a downward pricing bias.

The staff observed that the upward and downward respective biases of these instruments result in pricing spreads that it considered in evaluating the ESOARS.

The staff commented that registrants will need to exercise significant judgment to select an appropriate fair value or range of fair values that is within the layoff/tracking instrument spread. For the fair

value to be appropriate, the staff believes that registrants should minimize the pricing spread and estimate an appropriate fair value by:

- Refining the estimate of fair value and not simply lowering compensation cost; and
- Focusing on the design of the instrument and the creation of a competitive market for the instrument.

Given the early state of development for such instruments, the staff specifically encouraged registrants to benchmark the market clearing price of such instruments to the estimated spreads. The staff observed that the results of the benchmarking exercise would provide more support that the ESOARS yield an appropriate pricing mechanism. The staff commented that it is willing to accept ESOARS as a pricing mechanism for share-based payments if the price or range of prices for the instrument is within a spread that results from an appropriately designed instrument and marketing approach.

#### Replacement Cost and the Valuation of Acquired "Scarce" Intangible Assets

The three generally accepted approaches to determining fair value are the market, income, and replacement cost approaches (see Statement 157, paragraph 18). At the conference, the SEC staff discussed the calculation of replacement cost in the context of scarce intangible assets acquired in a business combination. In determining the fair value using this approach, the staff advised that registrants should analyze whether a market participant would pay a premium for the benefit of having the asset available for use today, rather than waiting until it could be

## Financial Reporting

internally developed or is otherwise available.

The staff observed that if a registrant would pay a premium for the immediate acquisition of an asset, the replacement cost should include an “opportunity cost” calculated as the cash flows foregone during the time it takes to obtain the assets. The staff suggested that registrants consider the following questions to determine whether the replacement cost should include such an opportunity cost:

- Is it difficult to replace?
- Does it require a long period of time to replace?
- Is it scarce?
- Is it critical to the business operations?

### Fair Value Election

The staff discussed the tension between FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, and other U.S. GAAP. Under the fair value option, registrants can elect to irrevocably measure certain financial items at fair value and subsequently recognize all changes in the fair value of those items in earnings.

The staff observed that it may not be appropriate to elect the fair value option for financial assets or liabilities that include embedded non-financial features such as substantive performance obligations. For example, a general partner’s financial interest in a partnership might include a commitment to perform management services for the partnership. If the general partner elected to carry its partnership interest at fair value, the value of unperformed management services might be included in the fair value of the interest. If so, the general partner would recognize unearned management fees through the change in the carrying value of its interest in the partnership, recognition that would be

prohibited by SAB No. 104, *Revenue Recognition*. The staff urged registrants with financial assets and liabilities that contain substantive embedded non-financial features performance obligations to carefully evaluate whether those instruments are eligible for the fair value option.

The staff also observed that registrants electing the fair value option for existing held-to-maturity (HTM) or available-for-sale (AFS) securities must assess the securities for other-than-temporary impairment at the balance sheet date *preceding* the election. If such impairment exists, the registrant should report the loss in earnings in the period preceding the adoption of Statement 159. That is, registrants are prohibited from including the impairment in the transition adjustment.

Similarly, the staff advised that registrants should reassess the continued classification of their HTM securities (as HTM) at the balance sheet date preceding the initial election of the fair value option for those securities. If continued classification as HTM is no longer appropriate, registrants should reclassify the securities to AFS in the period preceding adoption. The staff believes that reclassification into trading prior to adoption would not be appropriate. The staff further believes that in general, reclassification of an HTM security to AFS in the period preceding the adoption of the fair value option for that security would not challenge or “taint” the continued classification of other HTM securities as long as the adoption is substantive.

## Revenue Recognition

### Software Revenue

The SEC staff discussed revenue recognition for a contract to deliver multiple units of the same hard-

ware product that is within the scope of SOP No. 97-2, *Software Revenue Recognition*. SOP 97-2 is generally discussed in terms of revenue recognition for software and postcontract customer support (PCS) for that software. However, revenue recognition for hardware could be subject to the guidance in SOP 97-2 for one of the following reasons:

- There is software embedded in the hardware that is more than incidental to the arrangement; or
- There is software that is more than incidental to the arrangement and essential to the functionality of the hardware.

The staff discussed two conditions that may make it difficult to apply the provisions of SOP 97-2 to this contract:

- The remaining deliverables are multiple units of hardware that will be delivered over a long period of time; and
- Vendor specific objective evidence (VSOE) of fair value does not exist for such hardware.

Under SOP 97-2, revenue recognition is generally deferred if the undelivered elements cannot be valued by VSOE. Therefore, one might conclude that no revenue may be recognized until all of the hardware has been delivered. However, SOP 97-2 contains the following exceptions in paragraph 12:

- When the only undelivered element is PCS, then the entire fee can be recognized ratably;
- When the only undelivered element is services that do not involve significant production, modification, or customization of software, the entire fee can be recognized over the period during which the services are expected to be performed; and
- By analogy, when the only undelivered elements are both PCS

and services and VSOE of fair value does not exist for PCS or services or both, then the entire fee can be recognized over the longer of the PCS or the service period.

The staff believes that registrants can use judgment, apply the above exceptions by analogy to transactions involving undelivered hardware, and recognize revenue proportionate to the total remaining contracted revenue amount in this fact pattern. However, the staff cautioned that registrants using these methodologies should not recognize revenue prematurely and that any discount should be recognized proportionately over the life of the arrangement. The staff provided the following example to illustrate application of the methodology:

*A company has an arrangement in which the remaining deliverables are 100 units of Hardware Product A and 200 units of Hardware Product B. Both Hardware Products are in the scope of SOP 97-2 and VSOE of fair value is not available for either product. The staff observed that it would not object if revenue were recognized based on a strictly consistent ratio of both products. That is, one unit of Product A revenue would be recognized for every two units of Product B. If four units of Product A and four units of Product B were sold, to keep the ratio strictly consistent, revenue would be recognized for two units of Product A and four units of Product B.*

### **Multiple Deliverables and Joint Steering Committees**

The SEC staff discussed joint steering committees in the context of multiple element arrangements. Under EITF Issue 00-21, revenue is measured for a deliverable based on an allocation percentage equal to the fair value of the deliverable divided by the fair value of the

whole arrangement and recognized when SAB 104 criteria are met. The fair values should be based on reliable and objective evidence of fair value of the deliverables and of the whole. Joint steering committees that oversee collaborative research and development arrangements are typically established in the biotechnology industry, and the staff discussed whether a vendor's participation in such a committee represents a deliverable for revenue measurement purposes.

If a vendor is required to participate in a joint steering committee, or if failure to participate would call its performance into question, then the staff observed that the presumption exists that committee participation is obligatory and should be evaluated as a potential deliverable. Registrants should fully evaluate the explicit and implicit obligations in the contract, and consider inconsequential or perfunctory deliverables as defined in SAB 104, to make a thorough determination. Based on this framework, if a registrant concludes that participation on a joint steering committee is on the level of a deliverable, the staff advised that the registrant should consider this deliverable in the allocation and measurement of revenue.

### **Errors**

At the 2006 conference, the SEC staff discussed the subject of quantitatively large errors and whether such an error can be deemed immaterial after considering qualitative factors. Although the staff said that it believes that a large error can be immaterial, some conference participants might have perceived the staff's view to be that the staff doesn't give much weight to qualitative factors in this situation, because in the past the staff observed that it could hypothesize

only two very limited circumstances in which large errors could be immaterial – errors in break-even years and in discontinued operations. At the 2007 conference, the staff attempted to dispel this misperception, stating again that it believes that large errors can be immaterial and explaining its views.

The staff stressed that registrants will need to have compelling support for a conclusion that a large error is immaterial, including a list of the qualitative factors that make the size of the error unimportant. SAB No. 99, *Materiality*, lists a number of factors that may render a quantitatively small misstatement of a financial statement item material. The staff cautioned that the absence of factors listed in SAB 99 is not sufficient basis to support a conclusion that a large error is immaterial. That is, the determination that a large error is immaterial must be supported by the presence of persuasive qualitative information. The staff commented that it will not provide a list of qualitative factors that could render a larger error immaterial, because such factors are likely to be specific to a company's particular situation.

The staff encouraged registrants to focus on the Supreme Court's view that a fact is material if there is a substantial likelihood that the fact would have been viewed by the reasonable investor as having significantly altered the total mix of information available. If a registrant can support the supposition that a reasonable investor would conclude that the size of the error doesn't matter, i.e., a reasonable investor would not consider the error to have significantly altered the "total mix" of information, the staff would be less likely to challenge the registrant's conclusion.

## Financial Reporting

The staff cautioned that this is a high hurdle to clear, and encouraged registrants to consult with the staff when making difficult materiality determinations.

### Judgment and the Review Process

Given the focus of many of the speeches on the need for professional judgment, the SEC staff also discussed the circumstances in which it might question a registrant's accounting judgment. In short, the staff asks questions when it can't understand the accounting treatment because:

- The basis for an important judgment is counterintuitive or unclear from the disclosure;
- The judgments disclosed appear to be inconsistent with other judgments or assumptions made by the registrant; or
- The accounting literature cited by management to support a position has been superseded.

The staff pointed out that it asks questions to understand a registrant's transaction, the accounting literature applied, and the basis for the registrant's judgments. The questions are not an indication that the staff has concluded that the registrant is incorrect. The staff encouraged companies to provide thoughtful responses that explain their accounting judgments. The staff indicated that there is no need for a registrant to rush to restate in response to staff comments.

## SEC Rules and Regulations Issues

### Experts and Consents

With the expanded use of fair values in financial statements, the SEC staff noted that it has seen an

increase in references to the work of valuation specialists and others whose work is used by registrants in preparing their filings. This has led to a number of questions as to whether the specialist is an expert and a consent is required. Securities Act Rule 436 requires the consent of an expert in the following circumstances:

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

The staff interprets Rule 436 and the related Exchange Act reporting requirements broadly. The staff believes that by referring to the work of the specialist, a registrant appears to be transferring some, or perhaps all, of the responsibility for an item in the financial statements to the specialist. Therefore, even though the reference does not quote or summarize the specialist's report, a consent is needed. Similarly, although no consent is needed in an Exchange Act report, the staff believes that users of an Exchange Act report deserve to know who the specialist is, so the specialist must be named.

The staff summarized the requirements as follows:

- If a registrant refers to a specialist in a Securities Act filing, the specialist must be named and a consent must be provided, but the specialist does not need to be listed in a separate "experts" section of the filing.
- If a registrant refers to a specialist in an Exchange Act report, the specialist must be named but a consent is not needed unless the report is incorporated by reference into a Securities Act

filing (e.g., an effective registration statement on Form S-3 or S-8 or a subsequently filed registration statement that incorporates by reference previously filed Exchange Act reports).

Thus, registrants should use caution in drafting Exchange Act reports, making sure they name a specialist and provide a consent when necessary, and avoiding references to specialists if they will not provide a consent. The staff observed that if a registrant takes responsibility for the valuation and does not make a reference to the specialist, there is no need to obtain a consent for a Securities Act filing and no need to name the specialist in an Exchange Act filing.

The staff provided the following guidance on the wording of consents:

- A specialist can state that it does not admit to being an expert;
- A specialist cannot deny being an expert; and
- A specialist cannot attempt to limit liability by including language stating which party is responsible for disclosure (for example, stating that responsibility for the valuation rests solely with the registrant would not be appropriate).

### MD&A

The SEC staff discussed MD&A requirements for fair value measurements, analyzing pro forma financial information, and off-balance sheet arrangements. The staff reminded registrants of the Regulation S-K, Item 303 requirement to discuss any known trends or uncertainties that are reasonably expected to have a material impact on financial condition, results of operations, liquidity, and capital resources. The staff's general view is that the more material a registrant's exposure due to the sub-

prime crisis or any other situation, the more likely additional disclosure would be beneficial. Registrants should use judgment in determining how much additional disclosure to provide as the MD&A rules are principles-based.

### Fair Value Measurements

In their critical accounting policies disclosures, registrants should identify the judgments and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions. The staff observed that the discussion of fair value measurements should be more robust than, for example, “fair value determination requires judgment and proprietary models are used.” Rather, when registrants make extensive use of models to estimate fair value, the staff advised them to disclose:

- The types of models used to develop fair value;
- The significant inputs into those models, highlighting those with the greatest potential to affect the value derived;
- The assumptions for the most significant inputs; and
- If the assumptions have changed from prior periods, why the registrant has made the change.

Further, the staff observed that registrants will require judgment to classify valuation modeling inputs into the three levels defined in Statement 157. Level 1 represents inputs from active markets for identical assets or liabilities, Level 2 represents observable inputs for similar assets or liabilities, and Level 3 represents unobservable inputs. If a registrant reclassifies inputs between Level 2 and Level 3, the staff recommends that registrants include the following disclo-

tures in critical accounting estimates:

- The nature of the inputs that were no longer observable; and
- The techniques used to determine fair value in light of the reclassification to Level 3.

### Pro Forma Information

Item 303 requires registrants to present MD&A for the three-year period presented in the financial statements that are included in the filing. The staff acknowledged that there may be situations where it is appropriate to supplement the required MD&A with an MD&A that analyzes pro forma amounts when period-to-period comparability is affected by large business combinations or a significant change in an entity's basis due to push down accounting or a leveraged buyout transaction. Registrants should consider the need for a pro forma MD&A based on the:

- Impact of the transaction on an analysis of results;
- Nature of pro forma adjustments; and
- Overall relevance of a supplemental MD&A discussion.

Registrants should prepare the pro forma financial information discussed in MD&A in accordance with Article 11 of Regulation S-X. Article 11 requires that pro forma financial information reflect only the effect of the transaction and do so for only the fiscal year preceding the date of the transaction and the subsequent interim period. The staff observed that registrants should explain how the pro forma presentation was derived, why such presentation and discussion is meaningful, and the risks associated with using such a presentation and discussion. Further, when registrants provide a pro forma MD&A, they should include a pro forma income statement with

adjustments as part of MD&A or include it elsewhere in the filing.

### Off-Balance Sheet Arrangements

The staff recommended that registrants with off-balance sheet arrangements such as commercial paper conduits, structured investment vehicles and collateralized debt obligations provide the following disclosures in addition to those required by Item 303(a)(4):

- Type, quality and weighted average life of assets held in the off-balance sheet entity;
- Forms of funding (e.g., commercial paper, medium-term notes) and any difficulties experienced by the entity in obtaining financing;
- Any material write-downs or downgrades of assets held by the off-balance sheet entity and maximum limit of losses to be borne by any first loss note holders;
- Types of variable interests held in the off-balance sheet entity; and
- Whether and why the registrant purchased commercial paper or other securities from any off-balance sheet entity it manages.

The staff further recommended that registrants with off-balance sheet arrangements disclose additional liquidity information such as obligations under any existing liquidity facilities or written put options including:

- Funding triggers and terms limiting obligations to perform;
- Nature of the registrant's obligations under the facilities (e.g., purchase of commercial paper at a given price) and ranking of registrant's obligations with any other liquidity providers;
- Whether the registrant provided or assisted the off-balance sheet entity in obtaining any other

## Financial Reporting

type of support or has current intentions to do so; and

- Potential impact on the registrant's debt covenants, capital ratios, credit ratings, or dividends, should consolidation be required, or if the registrant incurs material losses associated with the entity.

The staff observed that registrants that have identified consolidation of variable interest entities as a critical accounting policy may want to consider discussing:

- Scenarios where the registrant would have to consolidate the off-balance sheet entity, and the registrant's expectation of the likelihood of such consolidation; and
- The frequency with which the registrant reconsiders, and the typical triggers that require the registrant to reconsider, whether it is the primary beneficiary of the entity.

If the registrant expects to realize a material loss as a result of its involvement with an off-balance sheet entity, it should disclose the amount of the expected loss.

In addition, under FASB Interpretation No. 46R, *Consolidation of Variable Interest Entities*, a registrant that holds a significant variable interest in a variable interest entity but is not the primary beneficiary must disclose maximum exposure to loss as a result of its involvement with the variable interest entity. The staff encouraged registrants to explain what exposures the disclosed maximum loss reflects (including both on and off balance sheet exposures), and what would need to happen for the company to incur the maximum loss.

The staff observed that one indication of the need for disclosure beyond the minimum requirements of Item 303 is the discussion of off-

balance sheet arrangements in the risk factor disclosures required by Item 503. The staff also advised that registrants can aggregate information to the extent that it is comparable among material off-balance sheet entities.

The staff has also recently outlined suggested disclosures related to off-balance sheet entities in a letter sent to two dozen large banks, investment banks, and insurance companies. The letter can be accessed at [www.sec.gov/divisions/corpfin/guidance/cfoffbalanceltr1207.htm](http://www.sec.gov/divisions/corpfin/guidance/cfoffbalanceltr1207.htm).

### Product and Service Revenue Presentation

The SEC staff discussed the Regulation S-X, Rule 5-03(b) requirement to display product and service revenue separately on the income statement. The staff observed that when registrants are unable to separate multiple element arrangements under revenue recognition and measurement guidance (e.g., SOP 97-2 and EITF Issue 00-21) they are not precluded from separately displaying product and service revenue. Based on facts and circumstances, the staff noted that registrants should select the presentation that is most meaningful to their investors.

The staff advised registrants to select a method for separating the revenue lines that is reasonable. The staff commented that such methods include the residual method (total consideration less the fair value of delivered products) or an allocation method where the service revenue percentage is consistent with that of comparable companies. When such methods are used, the methodology should be consistently applied, clearly disclosed and not misleading. The staff cautioned that allocations based on contractually

stated amounts would not be acceptable.

### Form 8-K Item 4.02

The SEC staff reminded registrants of the need to file an Item 4.02 Form 8-K if previously filed financial statements can no longer be relied upon. The instructions to Form 8-K state that if a registrant previously has reported substantially the same information as required by Form 8-K, the registrant does not need to file a separate Form 8-K to report the event. However, the staff clarified in a Frequently Asked Questions document (available at <http://www.sec.gov/divisions/corpfin/form8kfaq.htm>) that a triggering event under Item 4.02 must be reported on Form 8-K even if the event had previously been disclosed in a periodic report. Despite the guidance in the FAQ, the General Accountability Office (GAO) noted a number of restatements that were disclosed in quarterly or annual reports rather than on Form 8-K in its report, *Financial Restatements*, dated July 2006. The GAO recommended that the Commission end this practice of so-called "stealth restatements" by codifying the guidance in the FAQ. The staff commented that it plans to implement the GAO's recommendation and recommend rulemaking to codify the FAQ requirement in Form 8-K.

## International Reporting Issues

International Financial Reporting Standards was a key topic at the conference. The SEC staff observed that its reviewers and the review process for filings by foreign private issuers are the same as that used for domestic registrants. Further, just as the staff comments

on the application of U.S. GAAP, the staff comments on the application of IFRS.

Based on its reviews and increased acceptance of IFRS, the staff emphasized the importance of faithful and consistent application of IFRS worldwide. The staff reminded registrants of the three-step process dictated by IFRS for evaluating its application when there is no direct IFRS guidance:

1. Look to the IFRS standards, interpretations and then the implementation guidance;
2. Refer to the conceptual framework for IFRS; and then and only then
3. Look to other GAAP that is based on a similar conceptual framework. That is, registrants cannot look to U.S. GAAP until they have completed the first two steps in the process.

During 2007, the staff reviewed virtually the same registrants that it had reviewed in 2006, that is, Form 20-F filers that prepared their financial statements in accordance with IFRS. The staff considered the 2006 reviews of the 2005 Forms 20-F as key, since it was the first year that many European companies were required to implement IFRS in their primary financial statements. The staff reported that registrants were generally responsive to the comments it had made in 2006 and that the issues noted during the 2007 reviews were no more pervasive or more significant than those seen in reviews of domestic filers.

Before the staff communicates its views to a foreign registrant, it consults with the registrant's home country regulator, especially on matters that are novel or unprecedented. The staff has also developed more formal protocols for interacting with other regulators. These include participating in the

International Organization of Securities Commissions' (IOSCO) Standing Committee on Multinational Disclosure and Accounting, cataloguing decisions made concerning application of IFRS in an IOSCO database, and developing work plans and establishing dialogues with other regulators.

The Chairman of the FASB, Robert Herz, and the staff commented that the ultimate goal is a single set of high-quality accounting standards established by a single, independent standard setter. Mr. Herz observed that significant issues exist in the potential plan to allow domestic issuers to prepare IFRS financial statements. To address these issues, Mr. Herz recommended the development of a U.S. plan to specify the required action steps, related milestones, and target dates to support the acceptance and use of IFRS by U.S. investors and financial statement preparers.

## Internal Control Reporting

### Guidance for Management

The SEC staff discussed and emphasized certain specific aspects of the SEC's interpretive guidance for management released during the summer, including the following four areas:

- *Evaluation of the design of a company's ICFR* – The staff highlighted the importance of early evaluation of the design of controls based on two questions: "Do I have controls in place that address these risks?" and "If so, are they designed such that they can effectively prevent or detect misstatements that could result in material misstatements in the financial statements?"

- *Focus on areas of higher risk* – The staff observed that the "framework provided in the [SEC's] guidance requires management to gather more evidence in higher risk areas, while at the same time provides flexibility in the evidence needed to support the effective operation of controls in lower risk areas." The SEC's guidance also requires management to consider areas of potential fraud in the control assessment.
- *Evaluation of deficiencies* – The staff pointed out that many reported material weaknesses are a direct result of year-end audit adjustments. Companies should assess whether the control breakdown occurred in the fourth quarter or earlier in the year. A year end adjustment may indicate that the control system is not adequately preventing or detecting errors throughout the year. When adjustments are identified, management should consider the root causes and whether the internal control system is designed to address them. A control system's ability to provide timely identification of control breakdowns before they result in errors in the financial statements is an important component of effective internal control. It does not take an error in the financial statements to have a material weakness. Finally, the staff noted that it may request information about management's evaluation of deficiencies in order to gain an understanding of how identified deficiencies were determined to be less severe than a material weakness.
- *Disclosures of material weaknesses* – The staff commented that it believes material weakness disclosures are sometimes difficult for investors to understand and put into context. To address this

## Financial Reporting

concern, the staff suggested that management consider distinguishing between material weaknesses that may have a pervasive impact and those that do not. If a material weakness is related to an entity level control, more specific disclosures as to the impact should be included in the filing.

### Newly Acquired Companies

The SEC staff discussed ICFR reporting requirements for businesses acquired during the past fiscal year. In FAQ No. 3 from the SEC's *Management Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Reports – Frequently Asked Questions*, the staff acknowledged that conducting an assessment of the controls of an acquired business might not always be possible in the year of acquisition. While FAQ 3 has

historically been informally understood to allow relief from reporting on the ICFR of any businesses acquired in the most recent fiscal year, the staff encouraged registrants to focus on and address the needs of investors, questioning why a registrant would not assess controls at a business acquired during the year if an assessment could be performed.

The staff also indicated that it had never intended for FAQ 3 or the relief provided by the SEC in December 2006 that allows newly public companies to report on ICFR for the first time in their second Form 10-K to apply to reverse acquisitions. The staff commented that if a reverse acquisition had been consummated at the beginning of the year, and the Form 8-K reporting the transaction included Form 10 information, the staff would expect to see an assessment

of ICFR in the registrant's first Form 10-K. The staff encouraged consultation when determining which entity in a reverse merger is subject to ICFR and for what period.

### 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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Material discussed in this *Financial Reporting* letter is meant to provide general information and should not be acted upon without first obtaining professional advice appropriately tailored to your individual circumstances.