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Report on the AICPA SEC and PCAOB Conference

The annual AICPA National Conference on current SEC and PCAOB developments held on December 8-10 in Washington, D.C., provided insights into the Securities and Exchange Commission (SEC) staff’s views on various accounting and reporting issues. The remarks made by the SEC Chairman and members of the Office of the Chief Accountant may be accessed at the SEC’s website, www.sec.gov, under Speeches and Public Statements. The remarks made by members of the Division of Corporation Finance at the conference are available at conferences.aicpa.org/materials.

Overview

The “current financial crisis” dominated the headlines in 2008. The severe and sustained market decline called into question the values assigned to financial instruments, raised concerns about the recoverability of selected assets, and highlighted the need for full and transparent disclosure. These issues, which affect preparers, auditors, investors and lenders alike, were the focus of the 2008 conference.

The accounting standard-setting process is once again at the center of the debate with many questioning the appropriateness of fair value accounting, particularly in regards to financial instruments. Some have suggested that the

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values assigned are unreasonable and represent distressed sale prices rather than prices that would be achieved in an orderly market. Others have suggested that fair value accounting is one of the primary reasons the market has collapsed and have proposed banning its use on a temporary or even a permanent basis.

The SEC Chairman and the SEC staff strongly supported the use of fair value accounting. It increases transparency which in turn protects investors, enables informed decision making and results in efficient capital allocation. However, the SEC staff did acknowledge that determining fair value in an inactive or illiquid market is challenging and that additional interpretive guidance to, and improvement in, the standards is necessary.

In late 2007 auctions for auction rate securities began to fail and, with the benefit of hindsight, was a harbinger of things to come. Stock prices have continued their spiraling decline and investors have fled from the market, raising concerns about the recoverability and realization of assets. As a result, the SEC staff encouraged registrants to be diligent in their identification of potential indicators of impairment and rigorous in their assessments and valuations.

This crisis is global in nature and as such highlights the need for international financial reporting standards (IFRS), the most widely used set of standards in the world, to be of the highest quality. To this end, the SEC staff reiterated its support for the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) in their mission to establish and improve financial accounting and reporting

standards. The comments that follow elaborate on these topics and provide additional insights into the SEC positions on these and other accounting and reporting issues.

Fair Value Accounting

Measurements in Illiquid Markets

Although there are numerous views on the role that fair value does – and should – play in financial reporting, the SEC staff believes that all can agree on a few basic principles. Specifically, a fair value measurement is generally an estimate and is based on judgment. As a result, the real challenge lies in determining the best evidence of fair value in an inactive or illiquid market.

To address this challenge, the SEC and FASB issued a joint press release in September of 2008 discussing how fair value accounting should be applied in today's market. Although the guidance was intended as clarification of existing GAAP, there were mixed reactions. Some mistakenly viewed it as an amendment to Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements*, others as a suspension of fair value accounting, and yet others as the elimination of fair value in its entirety.

In an attempt to provide further clarification, the SEC staff made the following observations:

- A valuation model based on management's internally generated estimates of assumptions of willing market participants may be more appropriate, in some circumstances, than a measurement based on observ-

able data that requires significant adjustments.

- In an inactive market, if the measurement techniques previously employed are not available or do not represent fair value, they may need to be changed.
- Alternative measures such as fundamental, intrinsic or economic value based on a long-term intent to hold or the "true" or "real worth" are not appropriate.
- Unfavorable pricing or reduced liquidity do not represent a distressed sale or forced liquidation if the asset can be sold within a "usual and customary period." However, reduced transaction volume and wide bid-ask spreads may be indications that sales within such a period are not possible.

Prices obtained from brokers and pricing services can provide useful inputs into management's fair value analysis. However, management is ultimately responsible for the fair value measurements reflected in the financial statements. As a result, it is imperative that management understand how such values are determined including the source of information, the valuation methodology utilized, and the nature of any supporting quotes (e.g., binding versus non-binding). The staff also cautioned both management and auditors alike to not place undue reliance on such quotes simply because they are provided by a third party.

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As described above, determining fair value is a complex process – more an art than a science – that relies heavily on assumptions and estimates. As such, the accounting must be accompanied by transpar-

ent disclosure that enables users to understand the judgments made by management in arriving at the fair value estimates.

In March and September of 2008 the SEC staff issued letters to CFOs of large financial institutions (which are available on the SEC website due to their broad applicability) encouraging them to clearly communicate the effect of fair value measurements on their financial statements and suggesting specific disclosures to accomplish this objective. Although the letters resulted in expanded disclosures, based on feedback and staff observations, further guidance was warranted. As such, the SEC staff suggested registrants consider the following in crafting Management's Discussion and Analysis (MD&A) disclosures regarding fair value measurements:

- A sensitivity analysis based on other reasonably likely inputs and/or forward looking information
- The strengths and weaknesses of the valuation technique used and whether alternative techniques would have resulted in materially different fair values
- Other-than-temporary impairment (OTTI) on available-for-sale securities resulting from issuer specific conditions (e.g., credit) and from other accounting consequences (e.g., inability to hold until recovery)
- The extent to which broker or pricing services quotes were used
- The collateral underlying mortgage-backed securities, collateralized debt obligations, collateralized loan obligations, etc.
- The quantitative effect of a company's own credit risk and of the counterparty's credit risk on the fair value of derivatives

- How illiquidity was considered in the valuation
- The specific inputs that became unobservable and required transfer to Level 3 within the fair value hierarchy (i.e., fair value measurements based on significant unobservable inputs)
- The key drivers of fair value for each significant Level 3 asset or liability grouping and whether the input is observable or not
- The policy for transfers in and out of Level 3 (i.e., beginning of period, end of period, or date specific) as well as the amounts transferred and the gains/losses reflected in net earnings and other comprehensive income

Mark-to-Market Accounting

Under the Emergency Economic Stabilization Act of 2008, the SEC, in consultation with the Secretary of the Treasury and the Board of Governors of the Federal Reserve System, was required to conduct a study of "mark-to-market" accounting. The study focused on the impact of SFAS No. 157 on the balance sheets of financial institutions, the 2008 bank failures, and the quality of financial information available to investors. Additionally it reviewed the process used by the FASB in developing accounting standards and considered whether modifications of, or alternatives to, SFAS No. 157 would be feasible or advisable.

Although a final report was not scheduled to be released until early 2009, the SEC staff shared some preliminary findings:

- Most investors believe that, for financial reporting purposes, fair value provides a meaningful and transparent measure of an investment.

- Although the accounting standards have served the capital market well, inactive and illiquid markets require additional best practice guidance and expanded training and tools for determining fair value.
- An environment must be created in which reasonable judgments are developed and respected.
- The investment portfolios for many financial institutions consist primarily of available-for-sale securities and loans which are subject to the "other-than-temporary" model; this reflects a model that is challenging, subjective, and in need of revision or replacement.

Impairment Issues

Goodwill Impairment

Potential Indicators of Impairment

Under SFAS No. 142, *Goodwill and Other Intangible Assets*, an interim impairment test is required if an "event occurs that would more likely than not reduce the fair value of a reporting unit below its carrying value." Although SFAS No. 142 provides examples of events or circumstances that would require such an assessment it was never intended to be a comprehensive list and may not have contemplated the type of market turmoil that exists today. As such, the SEC staff identified additional potential indicators of goodwill impairment for registrants to consider:

- Other impairment charges or valuation allowances
- Recent cash or operating losses due to market conditions that are expected to continue
- Weakness in a particular industry (e.g., airlines, auto, banks, retail)

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- An inability to meet quarterly expectations or downward revisions to forecasts
- Restructuring plans including store closures and layoffs
- A decline in market capitalization below book value

The SEC staff indicated that it expects more goodwill impairments than in prior years. As a result of the recent and prolonged market declines, many registrants are faced with book values in excess of market capitalization. However, the SEC staff acknowledged that market capitalization is not necessarily synonymous with fair value and may not capture the true value of a reporting unit. In such situations the SEC staff strongly encouraged registrants to identify the nature of any differences through a reconciliation of the aggregate fair value of reporting units to the market capitalization.

Registrants frequently include a control premium (which would not be reflected in market capitalization) when determining the fair value of reporting units. Such inclusion is consistent with guidance in SFAS No. 142 which states that an entity might derive “substantial value” from the ability to control. However, the SEC staff noted that significant judgment is required when estimating such premiums and that assessments should be well thought out, entity specific, and thoroughly documented. Any control premiums based on an arbitrary percentage of market capitalization or a “rule of thumb” would be inappropriate and unacceptable.

In light of the volatility of the market, the SEC staff suggested that it may be more appropriate to base market capitalization on a reasonable period of days prior to the

test date, as opposed to the actual single test date. Similarly subsequent stock price declines may be indicative of factors that should be considered in an impairment analysis. For example, some declines may reflect information that had been known to management as of the testing date – just not yet known to the market.

Additionally the SEC staff emphasized that assumptions used to calculate the impairment of goodwill should be consistent with the assumptions used when assessing long-lived assets and intangible assets for impairment and determining valuation allowances for deferred tax assets.

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The accounting should be accompanied by a robust discussion of the assessment process within MD&A, regardless of whether or not a loss is ultimately recorded. If an impairment loss is recognized in the financial statements management should discuss the impact on the business through an historical perspective (i.e., what went wrong) as well as a forward-looking lens (i.e., expectations for the future). If an impairment charge is not required, despite the existence of potential indicators, management should provide “early warnings” about a possible future loss and describe the specific indicators and support for management’s conclusion. Lastly, if a loss is probable but an interim assessment is incomplete as of the filing date, the best estimate should be recorded and the preliminary nature of the loss highlighted. If the loss cannot be estimated management should describe the facts and circumstances leading to the failure of step one (i.e., carrying value of reporting unit in excess of fair

value) and provide a range of potential losses.

The SEC staff also reminded registrants of their disclosure requirements under SOP No. 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, and in relation to critical accounting policies. Registrants should describe the methodology for determining value including the valuation approach, the weighting of approaches (if applicable), the measurement date for market prices, key assumptions and a sensitivity analysis.

Disposal of Long-lived Assets

Under SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, a long-lived asset or disposal group classified as held for sale is to be carried at the lower of carrying amount or fair value less cost to sell. As defined in SFAS No. 144 a disposal group represents assets to be disposed of together in a single transaction, along with liabilities directly associated with those assets that will be assumed. As such, disposal groups will generally include other assets and liabilities that, on a stand-alone basis, would not be covered by SFAS No. 144.

Some have questioned whether impairment of a disposal group should be limited to the long-lived assets within the group or to the disposal group as a whole. The staff described a situation in which the shortfall between the carrying value and fair value (less costs to sell) of the disposal group exceeded the carrying value of the long-lived assets. In this fact pattern, the SEC staff believed that both views were reasonable. Under the staff’s interpretation of SFAS No. 144, the impairment could be (a) limited to the carrying value of the long-lived

assets or (b) reflected in its entirety by applying any excess against the carrying amount of other assets within the disposal group.

However, registrants applying the second view would be expected to clearly disclose and quantify the assets write-downs reflected in the financial statements. Additionally the SEC staff underscored that it believes that these alternative views do not extend to impairments involving an asset group held for use which, under SFAS No. 144, are specifically limited to the carrying amount of the long-lived assets.

Deferred Tax Assets

As indicated by SFAS No. 109, *Accounting for Income Taxes*, a valuation allowance is necessary if it is “more likely than not” that a deferred tax asset will not be realized. Significant judgment is required by management when making such an assessment and all available evidence – both negative and positive – must be considered and weighed. The basis for the ultimate conclusion may not be apparent or obvious.

As such, the SEC staff suggested that critical accounting policies describe the basis for management’s conclusions and the various factors considered such as:

- Cumulative losses in recent years and/or any losses expected in future periods
- Future taxable income projected and subject to judgment and uncertainty (e.g., tax planning strategies)
- The character of the deferred tax assets by jurisdiction (e.g., foreign, federal, state) and by nature (e.g., net operating losses, capital losses)
- Any changes in information from period to period

- Early warning of any increases in the valuation allowance that are reasonably likely to occur in the near term

IFRS for US Issuers

In late 2008 the SEC issued a roadmap for the potential use of IFRS by US issuers (the “Roadmap”) that could ultimately result in US issuers preparing financial statements in accordance with IFRS as issued by the IASB. As described by the SEC staff, the roadmap is a cautious and careful multi-year plan that contemplates possible future rule-making and is predicated on achieving several important milestones. The standards must be crafted, first and foremost, in the interest of the investor. The standard-setting process must be both transparent (open-due process) and independent (unbiased) to ensure the integrity and quality of the standards. Lastly, all stakeholders (preparers, auditors, investors, etc.) must be active participants in the standard setting process.

Assuming the milestones are met, in the view of one staff member, the question is no longer whether IFRS will be adopted for US issuers but rather when. There are differing views on the optimal way to proceed. Some have advocated that the US continue on its current path of convergence on a standard by standard basis through cooperation between the IASB and FASB. Others have urged an acceleration of the process through mandated convergence as of a date certain (e.g., 2014 as suggested in the proposed rule) – an approach advocated by many constituents in prior comment letters to the SEC. There are also differing views as to whether the ultimate goal should be full convergence (i.e., IFRS as

issued by the IASB) or whether a close approximation is sufficient (e.g., local jurisdiction IFRS).

In light of the importance of this issue – both within the United States and worldwide – the SEC staff strongly encouraged all interested parties to share their views through the comment process.

Other Accounting Matters

Embedded Conversion Features and Freestanding Warrants

Under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, derivatives are generally reflected at fair value and marked-to-market each period through a charge to earnings. However, if embedded conversion options and freestanding warrants that would otherwise meet the definition of a derivative are both (a) indexed to the reporting entity’s own stock and (b) classified in shareholders’ equity, fair value accounting is not required.

EITF No. 07-5, *Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity’s Own Stock*, was issued in 2008 to provide interpretive guidance as to the meaning of indexed to one’s own stock. It accomplishes this through a two-step test and numerous fact-specific examples. The SEC staff warned registrants that the conclusion reached in one example involving “reset” provisions represents a significant change in accounting. In a typical reset (or down-round) provision, if a company subsequently sells shares at a price that is lower than the conversion rate or strike price the original prices are adjusted down to the lower price. Under EITF No. 07-5 such features

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are no longer considered indexed to the reporting entity's own stock and will require fair value accounting as a liability under SFAS No. 133; this is a significant departure from existing practice.

Since the application of EITF No. 07-5 may result in significant changes in accounting (both for resets and other features addressed in the consensus) the SEC staff encouraged registrants to review financial instrument contracts and revisit prior conclusions regarding mark-to-market accounting.

Business Combinations

Business Acquisition Costs

Direct costs of a business combination, which are currently capitalized, will be expensed under SFAS No. 141R, *Business Combinations*. However, no transition guidance exists regarding costs incurred in periods prior to the adoption of the standard relating to acquisitions expected to close after the adoption. Some have argued that capitalization is inappropriate since such costs will eventually be expensed and thus do not qualify as an asset. Others have argued that capitalization is consistent with existing GAAP and that expensing would essentially represent an early adoption of SFAS No. 141R which is specifically prohibited.

The SEC staff indicated that it believes there are two reasonable approaches to dealing with such costs. The costs could either be expensed before the effective date of SFAS No. 141R (i.e., in 2008 for calendar year registrants) or capitalized and expensed upon adoption. Since this represents a policy decision, registrants should document, disclose, and consistently apply their accounting for acquisitions costs in this period.

Pushdown Accounting

Under Staff Accounting Bulletin (SAB) Topic 5J, parent debt related to an acquisition should be pushed down to the acquiree if: (a) the subsidiary will assume the parent's debt, (b) the proceeds of a subsidiary offering will be used to retire all or part of the parent's debt, or (c) the subsidiary guarantees or pledges its assets as collateral for the parent's debt. Although written in the context of a single subsidiary, the SEC staff confirmed that the guidance also applies when multiple subsidiaries are acquired.

Multiple acquisitions create an additional issue as to how the debt should be recorded on the financial statements of the individual subsidiaries. However, the SEC staff views this as a challenge, not as an impediment to the application of push down accounting. Based on the specific facts and circumstances, a number of presentations such as (a) reflecting 100% of the debt on the books of each subsidiary or (b) allocating the debt to the individual subsidiaries on a pro rata basis could be acceptable. Similarly, if the subsidiaries are jointly liable and a pro rata approach is taken, either a net presentation or a gross presentation (with receivables from other subsidiaries) could be appropriate. The SEC staff advised registrants to carefully consider the facts and circumstances and to report the acquisition related debt in a manner that properly portrays the risks and nature of the transaction.

Equity Method of Accounting

When refinancing debt, it is not uncommon for an entity accounted for under the equity method of accounting to secure new financ-

ing in an amount in excess of its existing debt and to distribute the excess to its investors. The SEC staff noted that cash distributions in excess of the carrying amount of an investment may be reflected as a gain, provided that the investor is neither liable for the obligations of the investee nor committed to provide further support. However, if the investor chooses to record the distributions in this manner, we believe that future equity earnings may not be reflected until the cumulative future equity earnings exceed the amount of the recognized gain.

Share-Based Payment Awards

The SEC staff discussed an issue involving ownership interests in a subsidiary of a private company granted to employees and accounted for under SFAS No. 123R, *Share-Based Payment*. In the specific fact pattern, the awards contained cash settlement provisions that required them to be treated as liabilities and re-measured to fair value each period until settlement. Additionally they contained a contingent feature that required they be exchanged for common stock of the parent in the event of the parent's initial public offering (IPO). Such an exchange would trigger a step-up in basis for tax purposes and thus increase the value of the ownership interests.

The issue was whether the likelihood of completing the IPO and realizing the related tax attributes should be incorporated in the measurement of fair value as of each period end or whether the effects should only be reflected if/when the IPO occurs. The SEC staff indicated that the effects should be incorporated in the re-measurements performed as of

each period end. Although performance awards that only vest in the event of a business combination are generally not recognized until consummation, the SEC staff did not believe such an analogy was appropriate to this fact pattern. However, the SEC staff did acknowledge that the uncertainty of the IPO might reasonably reduce the value ascribed to the tax attributes in the periods prior to the IPO.

Pension Accounting

Under SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, pension and OPEB plan assets and obligations must now be valued based on information and assumptions as of the year-end balance sheet date (the "measurement date") – not as of an interim date as previously allowed. In recognition of the time and effort involved in such valuations, as well as filing deadline constraints, the standard allows registrants that have sufficient controls in place to use a roll-forward technique when developing such measurements.

The SEC staff indicated that a roll-forward approach would be reasonable for purposes of determining pension and OPEB plan obligations. Registrants could determine the liability using assumptions as of an interim date and roll it forward for any significant events through year-end. The expectation would be that the results would not be materially different from an actuarial valuation performed as of the measurement date. However, the fair value of pension and OPEB plan assets with readily determinable market values and discount rates, which by their nature are subject to significant volatility, should be determined as of year-end.

Kick-Out Rights

Kick-out rights, as defined in 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*, are rights that allow limited partners to dissolve (liquidate) a limited partnership or otherwise remove the general partner. Such rights are generally indications that one party does not "control" an entity and that consolidation is inappropriate. However, barriers may exist that could preclude investors from exercising such rights. Similar rights involving the removal of decision makers and barriers to removal are also considered in FIN 46R, *Consolidation of Variable Interest Entities*.

To reach an appropriate conclusion regarding consolidation, registrants must determine whether a party controls an entity. As such, a thorough assessment of any potential barriers is critical. The SEC staff encouraged registrants to consider the nature and substance of barriers when determining whether they truly exist. The SEC staff also clarified that a determination that risk of removal is "remote" is not, in and of itself, a barrier but the reasons underlying this conclusion may be. For example, the belief that investors will redeem their investment before exercising kick-out rights is not a barrier to exercise. Conversely, the belief that investors will not exercise their rights for fear of a disruption to operations and resulting harm to their investments may be a barrier to exercise.

Related Party Considerations

An entity is subject to FIN 46R if (a) the voting rights of an investor are disproportionate to their obliga-

tions to absorb losses and rights to returns and (b) substantially all of the entity's activities either involve or are conducted on behalf of this investor or related parties of the investor. Questions have arisen as to whether close business associates may be considered related parties for purposes of this assessment.

The SEC staff believes that related parties should be identified in a manner consistent with the definition in SFAS No. 57, *Related Party Disclosure*. As such, close business associates may only be considered related parties if one party can control or significantly influence the other party, to the extent that one of the parties might be prevented from fully pursuing its own separate interest. The SEC staff also cautioned that past practice or future intent to collaborate would not be relevant to this analysis.

Materiality

Errors Impacting Multiple Years

Staff Accounting Bulletin (SAB) No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* requires that errors be quantified under both the rollover method (misstatement in current year income statement) and the iron-curtain method (misstatement of current balance sheet). Oftentimes, the iron-curtain method represents errors that have arisen in prior periods and that have accumulated over time (i.e., "cumulative error").

If the correction of a cumulative error would materially misstate the current year earnings, the financial statements for the prior years must be restated. Prior filings must be amended and an Item 4.02 Form 8-K regarding non-reliance filed if the

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prior financial statements are materially misstated. However, registrants may defer restatement until the affected periods are presented in future filings (e.g., comparable period in upcoming 10-K) if the errors are considered immaterial to the prior periods. As a result, determining materiality in prior periods is critical.

The SEC staff believes that some registrants and auditors have been misapplying the guidance when assessing materiality for each of the preceding years. Although a comparison of the cumulative balance sheet error to the prior balance sheets is required, a comparison to the net earnings of each of the preceding years is not. Rather, the materiality of the income statement error in each of the preceding years should be based on the portion of the balance sheet error that arose in each year. For example, if a registrant discovers a \$100 balance sheet error in the current year, \$80 of which arose ratably over the four prior years, only the \$20 error arising in each of the preceding years would be considered when assessing the impact on the prior income statements.

Assessing Materiality of Errors

Assessing materiality has been a frequent topic of discussion over the years with the most recent focus on whether a “large” quantitative error could be considered immaterial. The SEC staff reaffirmed its position that materiality should not be based solely on the quantitative amount of the error. Although the relative magnitude of an error is a factor and may in fact provide a preliminary view, the SEC staff does not rely exclusively on bright lines – numerical or percentage based – when determining materiality.

Rather, the SEC staff considers the total mix of information available and the views of a reasonable investor. This position is consistent with the Supreme Court’s view that “inferences a reasonable shareholder would draw from a given set of facts and the significance of those inferences to him” must be considered when assessing materiality. Such an approach would be appropriate regardless of whether the error appears within interim or annual financial statements.

Factors considered when assessing materiality should not be limited to those provided in SAB No. 99, *Materiality*. SAB No. 99 is not an exhaustive list of factors and was not originally drafted from the perspective of whether quantitatively large errors could be considered immaterial. As such, registrants should consider factors beyond those contemplated in SAB No. 99 including:

- Company specific trends and performance metrics that may influence investment decisions
- Unrelated circumstances that impact a factor ordinarily considered important to a reasonable investor (e.g., increase in magnitude of error as a result of abnormally small net income)

Other SEC Rules and Guidance

MD&A – Liquidity and Capital Resources

The objective of MD&A is “to give investors an opportunity to look at the registrant through the eyes of management.” It should provide an historical analysis of the registrant’s financial condition and results of operations and a prospective analysis of any known

trends that may impact the future. Such discussions are particularly important in today’s current environment and a “clean slate” approach rather than a mere updating of previous discussions is advisable.

Although MD&A disclosures have improved over the years, additional improvement – particularly regarding liquidity – is often warranted. The SEC staff encouraged registrants to consider the guidance in its prior interpretive releases (Financial Reporting Releases 36 and 72 issued in 1989 and 2003, respectively) when drafting liquidity discussions and to tailor and expand the disclosures to reflect the current economic crisis. For example, registrants should consider disclosing the following:

- Investing activities – the amount of expected capital expenditures, segregated between those that are discretionary and those that are not, and the anticipated funding sources
- Financing activities – the amount and sufficiency of funds available under short-term credit arrangements, any uncertainties regarding ability to access such funds, and the possible consequences
- Credit ratings – the long-term and short-term credit ratings, the factors impacting the ratings, and the potential implications of any changes
- Financial covenants – affirmative compliance with covenants and, to the extent contractually required financial ratios are disclosed, the actual ratios achieved
- Current market conditions – impact of market events on items such as illiquid investments, committed and uncommitted loan facilities, cash and securities held by banks or financial

institutions, future pension funding, share repurchase programs, and dividend payments

Internal Control over Financial Reporting

In 2008, the SEC delayed the requirement for auditors of non-accelerated filers to report on internal control over financial reporting until fiscal years ending on or after December 15, 2009. The deferral did not extend to management's assessment for non-accelerated filers which was required to be filed for the first time for fiscal years ending on or after December 15, 2007. The SEC staff performed a targeted review of the disclosures for management's assessment and noted a number of deficiencies. Some registrants failed to include any management assessment at all; others omitted required information such as the standard framework used or whether an auditor's report has been provided or is not required. The SEC staff noted that if disclosure did not comply fully with the requirements, the registrant would not be considered timely or current in its Exchange Act reporting. As such, the registrant would not be eligible to use streamlined registration statements such as Forms S-3 and S-8 or to continue to sell securities under effective registration statements.

The SEC staff also expressed concerns regarding the adequacy of disclosures involving material weaknesses. In many cases, registrants simply described the existence of a material weakness without analyzing and describing the underlying cause and effect. This frequently occurred when the material weakness resulted in a restatement and the material weakness was simply described as the adjust-

ment to the financial statements without identifying the control failure that resulted in the misstatement. The SEC staff reminded registrants that the disclosures should be sufficiently descriptive to allow investors to understand the cause of the control deficiency and to assess its potential impact on internal control over financial reporting.

Once published, management is not required to reassess or revise its conclusion regarding the effectiveness of internal control for subsequent events. Nevertheless, the SEC staff stressed that when a registrant restates previously issued financial statements to correct a material misstatement, management should consider the appropriateness of the original disclosures and modify or supplement them, as necessary, to ensure that they are not misleading in light of the restatement.

Experts and Consents

As defined in Regulation S-K, an expert is one who has "prepared or certified a report or valuation for use in connection with the registration statement." Experts named in registration statements filed under the 1933 Act, which most commonly include auditors and legal counsel, are required to provide consents agreeing to the inclusion of their reports. However, over the years it has become more common for registrants to refer to the work of third-party specialists that have assisted in valuations (e.g., purchase price allocations, financial instrument valuations). This practice has become even more widespread in the current illiquid and inactive market through the increasing use of brokers and pric-

ing services to value financial instruments.

The SEC staff currently believes that consents may, or may not, be required depending on who is assuming responsibility for the information. For example, if a registrant states that management determined the fair value of its financial instruments and, in so doing, considered or relied in part on a report of a named third-party no consent would be required. Conversely, if management attributes the fair value solely to a valuation performed by a third-party, the named party would be required to consent.

Accounting Judgments

Professional judgment has long been the cornerstone of the accounting profession. In years past, accountants were able to look to history when making such judgments (e.g., sales return allowance based on past experience). However, the introduction of fair value and its focus on expectations of the future has dramatically changed the landscape and judgments have become increasingly more challenging.

This fact was underscored by the Advisory Committee on Improvements to Financial Reporting (CIFiR) which was created by the SEC in 2007 and charged with the goal of reducing complexity in US financial reporting and improving the usefulness of financial information for users and investors. In its report released in August of 2008 CIFiR recommended that the SEC staff develop a policy on assessing the reasonableness of accounting judgments and outline the factors considered in such an assessment. Such a policy, once published, could serve as a

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roadmap for analyzing GAAP and drawing conclusions and reduce “second guessing” by the SEC staff.

This project has been added to the agenda of the SEC staff. However, in the meantime the SEC staff encouraged registrants concerned about “second guessing” to step back and reconsider their conclusions to ensure that: (a) the transaction is accounted for in a transparent manner, (b) GAAP has been carefully applied, and (c) individuals with the appropriate knowledge and expertise have been involved.

The SEC staff also emphasized that it is willing to consider the reasonableness of an accounting conclusion that is based on good faith and consistent with the substance of the transaction. Full and transparent disclosure surrounding the transaction would be helpful when evaluating the appropriateness of the conclusion. However, the staff cautioned that it is difficult to accept judgments involving a transaction that is “structured” to circumvent the objectives of a standard or designed in a way that is not transparent to investors.

Financial Reporting Manual

In late 2008 the SEC staff published its *Financial Reporting Manual* (Manual), a replacement of its staff training manual (last updated in 2000). Although intended as an internal training tool and reference document the Manual provides useful information for registrants and auditors alike and is now available on the SEC’s website.

The Manual addresses topics such as financial statement requirements (e.g., registrant, target, others); registrant specific matters (e.g., smaller reporting companies, for-

eign private issuers); specific types of transactions (reverse acquisitions); and disclosures (MD&A, non-GAAP). It was also expanded to include some SEC staff positions from joint meetings with the CAO SEC Regulations Committee. The intent is to update the Manual on a current basis as changes occur (e.g., new rules/regulations). To accomplish this, each section is date-stamped with the date of the last update (which initially is September 30, 2008).

International

Conversion from US GAAP to IFRS

Commencing in 2008, foreign private issuers that file financial statements under IFRS, as issued by the IASB, are no longer required to reconcile to US GAAP. As a result, some foreign private issuers that have previously filed US GAAP financial statements with the SEC are considering converting to IFRS for SEC reporting purposes. US investors accustomed to US GAAP financial statements would then be presented with financial statements retrospectively restated in accordance with IFRS. The issue is whether registrants should provide a reconciliation of the changes in the financial statements or disclose the material differences between US GAAP and IFRS.

Under IFRS I, first-time adopters are required to provide a reconciliation of financial statements prepared under “previous GAAP” (as originally filed) to those prepared under IFRS (as restated). However, this requirement generally would not apply in a situation in which a registrant converts from US GAAP to IFRS. Although foreign private

issuers have latitude in determining “previous GAAP” most identify local GAAP as previous GAAP – not US GAAP. Additionally, many registrants considering this change have already adopted IFRS in prior years and no longer qualify as first-time adopters.

Although there are no existing SEC rules addressing this situation, the SEC staff believes that foreign private issuers that convert from US GAAP to IFRS should provide a “bridge” for investors between the financial statements previously presented under US GAAP and those restated under IFRS. For a foreign private issuer that opts to adopt IFRS simultaneously for local and SEC reporting purposes the staff has suggested a two-step analysis. The analysis would reconcile: (a) US GAAP to local GAAP (previous GAAP) in a level of detail required under Item 17 of Form 20-F and (b) local GAAP to IFRS in accordance with IFRS I. For foreign private issuers that have adopted IFRS in prior years only a reconciliation of US GAAP to IFRS under an Item 17 approach would be required. The SEC staff is currently considering other presentations, as well as the placement of the information (i.e., whether it should be within the notes to the financial statements) and the level of auditor involvement (i.e., whether it should be subject to audit or review).

Shell Companies

US issuers are required to prepare their financial statements in accordance with US GAAP. However, in the past an exception had been made for foreign operating businesses that enter into a reverse acquisition with a public shell (i.e., a backdoor registration). In the Form 8-K following the consum-

mation of such transactions, such registrants were allowed to prepare their financial statements under local GAAP and provide a reconciliation to US GAAP consistent with Item 18 of Form 20-F. The understanding was that financial statements presented in all future filings (registration statements, current reports) would be restated in accordance with US GAAP.

In 2005, the SEC issued rules to prevent abuse associated with shell companies and to provide full and transparent disclosure to investors.

When a registrant emerges from shell company status, as a result of a reverse acquisition or business combination, the Form 8-K must now include all information that would be required in a Form 10 registration statement. As such, the SEC staff clarified that the previous accommodation described above is no longer appropriate and that financial statements of a foreign operating business must be prepared in accordance with US GAAP.

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.