Client Advisory

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Developments and Reminders Affecting Annual and Quarterly Disclosure

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This memorandum summarizes certain developments to keep in mind as you prepare your next annual or quarterly report.

New Executive Compensation Rules Effective

On November 7, 2006, the SEC's final new rules relating to executive and director compensation and related disclosure went into effect for companies with fiscal years beginning on or after December 15, 2006. These rules, implemented on August 11, 2006, and amended December 22, 2006, affect disclosures in annual reports as well as proxy statements, prospectuses and Forms 8-K. Significantly, the new rules require a new Compensation Discussion and Analysis (CD&A) to be included in a company's proxy statement (or its Form 10-K, if not incorporated by reference from the proxy statement) as well as new tabular disclosure.

The SEC intends the new rules to provide a more complete picture of (i) the total compensation earned by a company's named executive officers (i.e., a company's principal executive officer, principal financial officer and the three highest paid executive officers), as well as by its board of directors and (ii) the important financial relationships between companies and their executive officers, directors, significant shareholders and other related persons. The new CD&A section will be considered "filed" with (rather than "furnished" to) the SEC, meaning that the CD&A material included or incorporated in the Form 10-K will be covered by the chief executive officer and chief financial officer certifications required by SOX. Companies should plan on completing the CD&A prior to the filing of the Form 10-K, even if the proxy statement containing the CD&A will not be filed for a period of time after the Form 10-K is filed.

On December 22, 2006, the SEC adopted an amendment to these rules, effective on Federal Register publication in 2007, to more closely conform the new disclosure requirements with FAS 123(R)'s accounting rules. Under the amendment:

- The dollar values required to be reported in the Stock Awards and Option Awards columns of the Compensation Tables must now disclose the compensation cost of those awards, before reflecting forfeitures, over the requisite service period, as described in FAS 123R, and forfeitures are required to be described in accompanying footnotes.
- The Grants of Plan-Based Awards Table must now disclose:

► the grant date fair value of each individual equity award, computed in accordance with FAS 123R (and the Director Compensation Table must include footnote disclosure of this information).

► any option or stock appreciation right that was repriced or otherwise materially modified during the last completed fiscal year, including the incremental fair value, computed as of the repricing or modification date in accordance with FAS 123R (and the Director Compensation Table must include footnote disclosure of this information).

Large Accelerated Filers and New Form 10-K Filing Deadline

Pursuant to new filing deadlines adopted in December 2005, large accelerated filers will need to file their Forms 10-K for fiscal years ended on or after December 15, 2006 within 60 days after the fiscal year end. Accelerated filers that are not "large accelerated filers" will continue to have a 75-day filing deadline after fiscal year end.

Section 404: Extension for Compliance for Non-Accelerated Filers and Newly Public Companies, and Proposed Interpretive Guidance

Extension of Compliance Periods. On December 15, 2006, the SEC extended the date for non-accelerated filers to comply with Section 404 of the Sarbanes-Oxley Act. A non-accelerated filer will now have to provide a management's assessment regarding internal control over financial reporting in its annual reports for fiscal years ending on or after December 15, 2007 (instead of July 15, 2007), and to comply with the auditor attestation report requirement in its annual reports filed for fiscal years ending on or after December 15, 2008. This will allow for time for the Public Company Accounting Oversight Board (PCAOB) to adopt, and the SEC to approve, its proposed Auditing Standard to replace Auditing Standard No. 2.

A company that becomes an accelerated filer during the interim period will need to comply with Section 404's requirements as to accelerated filers. The relevant date for determination of accelerated filer status is as of year end, so that during the year a company will need to anticipate possible accelerated filer status as of year end due to the possible earlier need to comply with Section 404. In addition, a newly public company (including through an IPO, a registered exchange offer or other obligation to file Exchange Act reports) will no longer need to comply with the Section 404 requirements in the first annual report that it files after becoming an Exchange Act reporting company, and its first annual report will need to disclose the absence of the management report and attestation. A company becoming an Exchange Act reporting company at the beginning of a fiscal year will need to file its first annual report shortly after becoming public, so that the first annual report complying with Section 404 will be due for the following year and will cover the prior year (including any period in that year prior to

when the company was an Exchange Act reporting company). The management report filed without the attestation will be deemed "furnished" instead of "filed" and the annual report must disclose that the auditor has not so attested.

Guidance for Evaluation of Internal Controls. On December 20, 2006, the SEC proposed interpretive guidance for management regarding evaluation of internal control over financial reporting. The proposed guidance is intended to permit management to exercise its judgment in designing appropriate evaluation processes and set forth an approach by which management may conduct an evaluation of internal control over financial reporting. The proposed guidance is organized around two broad principles. The first principle is that management should evaluate the design of the controls that it has implemented to determine whether the controls adequately address the risk that a material misstatement in the financial statements would not be prevented or detected in a timely manner. The guidance describes a top-down, risk-based approach to this principle, including the role of entity-level controls in assessing financial reporting risks and the adequacy of controls. Under the SEC's approach, management should focus its evaluation process and the documentation supporting the assessment on those controls that it believes adequately address the risk of a material misstatement in the financial statements. For example, if management determines that the risks for a particular financial reporting element are adequately addressed by an entity-level control, no further evaluation of other controls is required. The second principle is that management's evaluation of evidence about the operation of its controls should be based on its assessment of risk. The proposed guidance provides an approach for making risk-based judgments about the evidence needed for the evaluation. This allows management to align the nature and extent of its evaluation procedures with those areas of financial reporting that pose the greatest risks to reliable financial reporting (i.e., whether the financial statements are materially accurate). As a result, management may be able to use more efficient approaches to gathering evidence, such as self-assessments, in low-risk areas and perform more extensive testing in high-risk areas. By following these two principles, the SEC believes that companies of all sizes and complexities will be able to implement its rules effectively and efficiently. Comments on the proposed guidance are due February 26, 2007.

PCAOB's Internal Controls Proposal

On December 19, 2006, the PCAOB proposed for public comment a new auditing standard, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, that would supersede its existing Auditing Standard No. 2 (AS No. 2). The comment period for the proposal, which is available on the PCAOB's Web site under Rulemaking Docket 21, ends

February 26, 2007. Following the end of such comment period, the PCAOB will consider whether to adopt a final standard, which will then be submitted to the SEC for approval.

The new standard (together with related SEC rules) would implement the internal control reporting requirements of Sarbanes Sections 103 and 404. Such proposed new standard is a principles-based standard designed to focus the auditor on the most important matters, increasing the likelihood that material weaknesses will be found before they cause material misstatement of the financial statements. The proposed standard also eliminates audit requirements that are unnecessary to achieve the intended benefits, provides direction on how to scale the audit for a smaller and less complex company, and simplifies and significantly shortens the text of AS No. 2. Specifically, the new standard would:

- direct the auditor to the most important controls and emphasize the importance of risk assessment;
- revise the definitions of significant deficiency and material weakness, as well as the "strong indicators" of a material weakness;
- clarify the role of materiality (including interim materiality) in the audit;
- remove the requirement to evaluate management's process;
- permit consideration of knowledge obtained during previous audits;
- direct the auditor to tailor the audit to reflect the attributes of smaller and less complex companies;
- refocus the multi-location testing requirements on risk rather than coverage; and
- recalibrate the walk-through requirement.

The PCAOB also proposed to revise the independence requirement that currently is embedded in the text of AS No. 2, which requires the auditor to seek specific pre-approval by the audit committee of any internal control related service. The PCAOB also proposed a related auditing standard, Considering and Using the Work of Others in an Audit, an independence rule relating to the auditor's provision of internal control-related non-audit services, and certain amendments to its interim standards, which is intended to further clarify how and to what extent an independent auditor may use that work to reduce the work the auditor otherwise would have to perform.

FASB's New Standard: Accounting For Uncertainty in Income Tax

In June 2006, the FASB issued interpretation No. 48 under FASB statement No. 109, Accounting for Uncertainty in Income Tax, to resolve many uncertainties about how public and private companies should report their income tax positions. These new standards become effective for years beginning after December 15, 2006. The new procedures are intended to primarily apply to taxpayers that issue certified financial statements for their cur-

rent financial accounting years that end on or before March 31, 2007.

PSLRA's Safe Harbor for Incorporation by Reference and Written Statements

The Private Securities Litigation Reform Act of 1995 (PSLRA) includes a safe harbor for earnings projections and other such forward-looking statements, written or oral, that are "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement." PSLRA provides that "meaningful cautionary statements" contained in an identified written statement may be incorporated by reference into oral forward-looking statements made by or on behalf of an issuer. Because this safe harbor expressly permits incorporation by reference with respect to oral statements, shareholder plaintiffs have argued that a corporate defendant's written statement (e.g., a press release) that incorporates by reference the "meaningful cautionary statements" contained in another written document (e.g., the company's annual report) is not entitled to "safe harbor" protection. However, in July 2006, an Iowa district court rejected this argument, holding that "[w]hile the Safe Harbor provision does not explicitly provide for incorporation by reference for written forward-looking statements," a defendant's ability to rely on the safe harbor in these circumstances was implicit in the statute. While this decision supports the argument that a press release containing forward-looking statements can fall within the safe harbor by incorporating by reference cautionary statements contained in prior SEC filings, a company's safer course is to avoid the issue altogether by repeating verbatim in its forward-looking press releases the same cautionary statements contained in its prior SEC filings.

Late SEC Filings as Bond Defaults: New York Trial Court Decision

On September 18, 2006, the Supreme Court of New York, New York County, held that the failure to timely file periodic reports was an indenture default even though the relevant indenture did not require timely periodic filings. In The Bank of New York v. BearingPoint, Inc., a central issue was whether a company's failure to file its Forms 10-K and 10-Q when required by the SEC constituted an event of default under a convertible bond indenture. In this litigation, the company failed to so file for a variety of publicly announced reasons, including the existence of material weaknesses in internal controls and financial accounting. Certain debenture holders sought to declare an event of default under the indenture's covenant default provisions that required the company to file with the trustee its SEC filings within 15 days after the filings were made with the SEC. In holding in favor of the debenture holders, the court reasoned that a reading of the indenture that required the company to file those reports whenever it actually filed them with the SEC would frustrate the purpose of Section 314(a) of the Trust Indenture Act (TIA) which, according to the court,

was to make the company's financial information available to debenture holders, to allow the holders to make informed decisions about their investment and guard against the risks attendant to incomplete information. Because the opinion was issued on summary judgment by a lower New York court, it is unclear whether the decision would be upheld on appeal. In addition, because the TIA does not directly incorporate the filing requirements described above into every TIA-qualified indenture and only obligates an issuer to make those filings as a matter of statute, the court did not address whether a failure to comply with the TIA would have any effect on an indenture that did not expressly incorporate that section.

SEC Issues SAB 108 on Quantifying Financial Statement Errors

On September 13, 2006, the SEC issued guidance in the form of Staff Accounting Bulletin (SAB) 108 on how errors, built up over time in the balance sheet, should be considered from a materiality perspective and corrected. SAB 108 provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. Two common approaches have been used to quantify such errors: quantification of the error as the amount by which the current year income statement is misstated; and the error as the cumulative amount by which the current year balance sheet is misstated. The SEC clarified that it believes that companies should quantify errors using both a balance sheet and an income statement approach and should evaluate whether either of these approaches results in quantifying a misstatement that (when all relevant quantitative and qualitative factors are considered) is material. SAB 108 also describes the circumstances where it would be appropriate for an issuer to record a one-time cumulative effect adjustment to correct errors existing in prior years that previously had been considered immaterial. While SAB 108 has no true effective date (since it represents the SEC's views as to proper interpretation of existing rules) SAB 108 indicates that November 15, 2006 is its reference point.

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