

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.

PCAOB Proposed Internal Controls Standards

The Public Company Accounting Oversight Board (PCAOB) is currently deliberating new internal control standards under Sarbanes Section 404. After adoption by the PCAOB, the SEC expects to consider these audit standards by the end of May or early June 2007. The SEC's goal is to implement new audit standards in time for the auditing of financial statements for the 2007 fiscal year and to make internal control review and audit more efficient and cost-effective. According to an April 4, 2007 press release, the SEC expects to focus on:

- ▶ Aligning the new auditing standard with the SEC's proposed new management guidance under Sarbanes Section 404, published for public comments on December 20, 2006, which management guidance focuses on internal controls with the greatest risk of material misstatement;
- ▶ Scaling the 404 internal controls audit to account for companies' particular facts and circumstances;
- ▶ Encouraging auditors to use professional judgment in their 404

audit process, particularly in their risk-assessment procedures; and

- ▶ Following a principles-based approach to determine when and to what extent the auditor can use the work of others.

According to John White, the Director of the SEC's Division of Corporation Finance, in an October 12, 2006 speech, a principles-based approach will start with laying out the key objectives of good reporting in the subject area and will then provide guidance explaining the objective and relating it to some common examples. Such an approach will tell a compelling story with the disclosure; will make that story relevant, qualitative and contextual; and will avoid mere quantitative disclosure that just repeats the data that is already in the financial statements.

FASB Issues New Standard for Reporting Assets and Liabilities at Fair Value

On February 15, 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, a standard that gives companies the option to report

certain financial assets and liabilities at fair value. According to a FASB news release, the standard's purpose is to reduce both complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently. The summary for SFAS No. 159, which will be effective as of the beginning of companies' first fiscal year beginning after November 15, 2007, indicates that the eligible items for this option includes:

- ▶ Recognized financial assets and financial liabilities except:
 - ▶ An investment in a subsidiary that the company is required to consolidate,
 - ▶ An interest in a variable interest entity that the company is required to consolidate,
 - ▶ Employers' and plans' obligations (or assets representing net overfunded positions) for pension benefits, other postretirement benefits, postemployment benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements,
 - ▶ Financial assets and financial liabilities recognized under leases (this does not include a guarantee of a third-party lease obligation or a contingent obligation arising from a cancelled lease),
 - ▶ Deposit liabilities (withdrawable on demand) of banks, savings and loan associations, credit unions, and other similar depository institutions, and

- ▶ Financial instruments that are classified by the company as a component of shareholder's equity;

- ▶ Firm commitments that would otherwise not be recognized at inception and that involve only financial instruments;

- ▶ Non-financial insurance contracts and warranties that the insurer can settle by paying a third party to provide those goods and services; and

- ▶ Host financial instruments resulting from separation of an embedded non-financial derivative instrument from a non-financial hybrid instrument.

Early adoption is allowed, so long as the company also applies the provisions of FASB Statement No. 157, *Fair Value Measurements*.

SEC Issues Guidance as to Restatements for Option Grant Accounting Errors

In January 2007, the SEC's Division of Corporation Finance issued guidance for companies required to restate multiple previously-issued financial statements due to accounting errors regarding stock option grants. The January guidance allows a company to amend only its most recent Form 10-K and include a comprehensive disclosure as to the restatement, even though in general all previously-filed financial statements with material misstatements must be amended. The guidance indicates that the comprehensive disclosure must include:

- ▶ An explanatory note at the beginning of the Form 10-K amendment that discusses the reason for the amendment;
- ▶ A Selected Financial Data section for the most recent five years as required by Regulation S-K Item 301, restated as necessary and with columns labeled “restated”;
- ▶ A Management’s Discussion and Analysis (MD&A) section as required by Regulation S-K Item 303, based on the restated annual and quarterly financial information, explaining the company’s operating results, trends and liquidity during each interim and annual period presented (discussions relating to interim periods may be incorporated into the annual-period discussions or presented separately);
- ▶ Audited annual financial statements for the most recent three years, restated as necessary and with columns labeled “restated”;
- ▶ If interim period information for the most recent two fiscal years as required by Regulation S-K Item 302 must be restated, information presented for the balance sheets and statements of income using a level of detail consistent with Regulation S-X Rule 10-01 (a)(2) and (3) and appropriate portions of Rule 10-01(b) and with columns labeled “restated” (although there is no need to present cash flow information, since this information is not required by Item 302);
- ▶ Footnote disclosure reconciling previously filed annual and quarterly financial information to the restated financial information, on a line-by-line basis and for each material type of error separately, within and for the periods presented in the audited financial statements, in selected financial data and in the interim period information;
- ▶ Disclosure referred to in a September 19, 2006 SEC Chief Accountant letter that applies to the restatement;
- ▶ Audited financial statement footnote disclosure of the nature and amount of each material type of error separately that is included in the cumulative adjustment to opening retained earnings;
- ▶ Audited financial statement footnote disclosure of the restated stock compensation cost:
 - ▶ For the most recent three years: restated net income and compensation cost and pro forma disclosures, required by FIN 123, *Accounting for Stock-Based Compensation* paragraph 45.c, as amended by FIN 148, for each annual period presented in the financial statements for which the intrinsic value method of accounting in APB Opinion 25 was used, with columns labeled “restated” as appropriate;
 - ▶ For each annual period preceding the most recent three years: disclosure of the information required by FIN 123 paragraph 45.c.2, the restated stock compensation cost that should have been reported for each fiscal year, with the total of the restated stock-based compensation cost reconciled to the disclosure of the cumulative adjustment to opening retained earnings (while the disclosure

required by paragraph 45.c.2. is net of tax, material tax adjustments related to the accounting for stock-based compensation should also be disclosed by year); and

- ▶ For companies that adopted FIN 123 using the retroactive restatement method specified in FIN 148 and/or FIN 123R, *Accounting for Share-Based Payment*, using the modified retrospective application method for all prior years for which FIN 123 was effective: the above disclosure should include the restated stock-based compensation pursuant to FIN 123 and the restated stock-based compensation cost that should have been reported under the accounting principle originally used for each period, presumably Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*;

- ▶ Appropriate revisions, if necessary, to previous disclosure:

- ▶ As discussed in “Staff Statement on Management’s Report on Internal Control Over Financial Reporting” (May 16, 2005), in disclosing material weaknesses that were identified, companies should consider including in their disclosures the nature of the material weaknesses, impact on financial reporting and control environment, and management’s current plans, if any, for remediating the weakness; and

- ▶ In light of the restatement and new facts discovered by management, including identification of any material weaknesses, companies must disclose the certifying officers’ conclusion regarding the effectiveness of disclosure

controls and procedures as of the end of the covered period.

FASB Votes Not To Delay New Tax Rule

On January 17, 2007, despite a high volume of comment letters requesting a one-year delay in implementation of its new rule FASB Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes*, that requires companies to take a more rigorous approach in determining future tax liabilities, the FASB voted unanimously not to postpone FIN 48 for another year. As passed, FIN 48 is effective for fiscal years beginning after December 15, 2006. Under FIN 48, a company’s tax position:

- ▶ Is first evaluated to determine whether it will more likely than not be sustained under examination, and

- ▶ If it meets the above threshold, is measured at the largest amount of benefit that is greater than 50% likely of being realized upon ultimate settlement (and this amount must be recognized in the financial statement).

FIN 48 was created to decrease the inconsistencies created by the amount of latitude companies had in determining future estimated tax assets and liabilities on the balance sheets.

On February 27, 2007, the FASB recommended that the FASB provide a better explanation of “ultimate settlement” (a phrase referring to the point at which a company may say with certainty

that it has finished accounting for the uncertainty in its tax position), and was expected to provide implementation guidance as to the meaning of “ultimate settlement” in time to help companies comply by the end of their first quarter of 2007. This proposal is currently being re-deliberated by the FASB.

SEC and International Financial Reporting Standards

At a January 15, 2007 Securities Regulation in Europe conference, John White, the Director of the SEC’s Division of Corporation Finance, indicated that the SEC is not trying to interpret or commandeer International Financial Reporting Standards (IFRS), adopted in 2005 by the European Union for European-listed companies, when reviewing financial statements for such European-listed companies. According to Mr. White, the SEC only wants to ensure issuers’ complete and faithful application of relevant accounting standards. He indicated that if questions cannot be resolved with the company itself, the SEC may find it appropriate to take up those questions with home country regulators. Foreign private issuers using IFRS or another country’s GAAP currently must reconcile financial statements to U.S. GAAP, and Mr. White mentioned the possibility of eliminating the need for this reconciliation by 2009.

On March 7, 2007, SEC Chairman Christopher Cox also announced at the SEC’s Roundtable on International Financial Reporting Standards that one

of the SEC’s goal is to eliminate the current U.S. GAAP reconciliation requirement, so as to allow a U.S. exchange-listed company to choose whether to report under IFRS or U.S. GAAP. Companies reporting using U.S. GAAP currently are not required to reconcile with IFRS. The SEC and the Committee of European Securities Regulators currently are working together to further the accounting standards’ consistent and faithful application.

SEC Issues Interpretations as to Regulation S-K Items

On March 13, 2007, the SEC issued guidance as to certain Regulation S-K Items, all of which must be disclosed in companies’ Form 10-K:

- ▶ Regulation S-K Item 201, which relates to the market price of and dividends on the companies’ common equity and related shareholder matters (Form 10-K requires this information as to all equity securities sold by the company during the period covered by the report that were not registered under the Securities Act), located at <http://www.sec.gov/divisions/corpfin/guidance/execcomp201interp.htm>;
- ▶ Regulation S-K Item 403, which relates to the security ownership of certain beneficial owners and management, located at <http://www.sec.gov/divisions/corpfin/guidance/execcomp403interp.htm>;
- ▶ Regulation S-K Item 404, which relates to transactions with related persons, promoters and certain control persons, located at

<http://www.sec.gov/divisions/corpfm/guidance/execcomp404interp.htm>; and

► Regulation S-K Item 407, which relates to corporate governance and also must be disclosed in Form 10-Q, located at <http://www.sec.gov/divisions/corpfm/guidance/execcomp407interp.htm>.

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