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Holiday Traditions Continued

More Highlights of the AICPA's December 5–7, 2005 SEC & PCAOB Conference

by Deloitte & Touche LLP's SEC Services and Assurance Services Groups

The December 13, 2005, issue of *Heads Up* featured the AICPA's National Conference on Current SEC and PCAOB Developments (the Conference); specifically, we focused on Conference content related to financial accounting and reporting in accordance with U.S. generally accepted accounting principles.

In this issue, we turn our attention to those speeches and other comments that dealt with (1) securities offering reform, (2) current and proposed SEC filing rules and regulations, (3) XBRL, and (4) current and proposed PCAOB initiatives. There are also two accounting matters (block discounts and warrants to nonemployees) thrown in for good measure.

While the speakers rightfully indicate that their remarks do not necessarily reflect the views of their organizations, the statements clearly provide insight into current concerns and priorities.

Certain of the SEC staff presentations are available on the Commission's Web site at www.sec.gov. We endeavor to be as accurate as possible and the information in this issue is our best attempt to capture the key accounting and financial reporting points made during the Conference. Please keep in mind, however, that we have not confirmed the accuracy of this *Heads Up* with the SEC staff or any other organization mentioned.

Consistent with last year, the SEC and PCAOB staffs used the Conference to explain upcoming or recent rule changes and their latest thinking on application of existing rules. Consult the table below for a list of topics included in this issue. For more details, look to the Appendix, which is organized by speaker.

Speaker	Topics Covered	Affects
Martin P. Dunn, *Deputy Director*, Division of Corporation Finance	• Securities offering reform	All SEC registrants.
Joel K. Levine, *Associate Chief Accountant*, Division of Corporation Finance	• Amendments to accelerated filer definition and filing deadlines	All SEC registrants.
Rachel Mincin, *Associate Chief Accountant*, Division of Corporation Finance	• Disclosures about off-balance-sheet arrangements	Companies that have entered into off-balance-sheet arrangements.
Sondra L. Stokes, *Associate Chief Accountant*, Division of Corporation Finance	• Disclosure controls and procedures and internal control over financial reporting • Block discounts • Warrants issued to nonemployees	All SEC registrants. Companies that estimate fair value of large blocks of financial instruments. Companies that issue warrants to nonemployees.
Jeff Naumann, *Enabling Technology Specialist*, Office of the Chief Accountant Keith Wilson, *Associate Chief Auditor*, PCAOB John Stantial, United Technologies John Philip, Infosys Technologies Limited Wayne Harding, XBRL US	• XBRL and the SEC voluntary filing program	All SEC registrants.
Herbert S. Wander, *Co-chair*, SEC Advisory Committee on Smaller Public Companies	• Smaller public company issues	Smaller public companies.

Speaker	Topics Covered	Affects

Craig C. Olinger, *Deputy Chief Accountant*, Division of Corporation Finance
 	
Susan Koski-Grafer, *Senior Associate Chief Accountant,* Office of the Chief Accountant
	• Recent rules affecting foreign private issuers
	    • First time application of IFRS rule
	    • Non-GAAP measures rule and IFRS financial information
	    • New rules on shell companies
	    • Securities offering reform rule
	• Reporting issues
	    • Internal controls over financial reporting under section 404 of the Sarbanes-Oxley Act
	    • Disclosure controls and procedures
	    • Guarantor information
	• International regulatory developments
		Those registrants that are foreign private issuers.

Charles D. Niemeier, *Board Member*, Public Company Accounting Oversight Board Douglas R. Carmichael, *Chief Auditor*, Public Company Accounting Oversight Board	• PCAOB developments • PCAOB standard setting update	All SEC registrants and their auditors.

Appendix: Summaries of Speeches and Other Comments
AICPA's December 5–7, 2005 SEC & PCAOB Conference

Speech by Martin P. Dunn, *Deputy Director*, Division of Corporation Finance

Securities Offering Reform

Effective December 1, 2005, significant reforms were made to the rules that govern registered securities offerings under the Securities Act of 1933. Deputy Director Dunn spoke at length describing the changes and their expected impact.

The reforms can be summarized in five general categories: (1) communication prior to and during registration, (2) shelf offerings, (3) prospectus delivery, (4) changes to periodic reporting disclosures, and (5) liability.

Communication

One of the objectives of the reform is to provide registrants added flexibility in communication during the registration and offering process. The degree to which the rules have been relaxed varies with the size and reporting history of the company. Large, closely followed, and "seasoned" issuers are granted the greatest flexibility; initial public offerings are granted the least. The relaxed rules allow companies to:

1. Provide information to investors through "free writing prospectuses," allowing regulators to focus on the content of the communication, rather than the method (written or verbal) by which the information is delivered, and
2. Continue to provide the marketplace factual business and financial information during what was previously a quiet period prior to the filing of a registration statement.

Shelf Offerings

The most notable of reforms to the shelf registration process is the creation of a new category of issuer, the "Well Known Seasoned Issuer." These are companies that are large, widely held, and have a public reporting history. This category of issuer can use a new automatic shelf registration; a short form filing that is immediately effective upon filing. This allows securities to be issued without the delay typically experienced between filing and effectiveness.

Prospectus Delivery

Physical delivery of the final prospectus is no longer required as long as it is readily accessible by investors.

Periodic Reporting Disclosures

Annual reports on Form 10-K now require:

1. Disclosure of risk factors (material changes in risk factors must be reported in the Form 10-Q);
2. The cover page of the Form 10-K to indicate whether the registrant is a well known seasoned issuer or a voluntary filer;
3. Well known seasoned issuers and accelerated filers to disclose unresolved material SEC comments that remain outstanding for more than 180 days as of fiscal year end.

Liability

The reforms also changed a number of the Securities Act liability provisions. These changes include the following:

1. Section 11 liability for underwriters and issuers in a shelf registration is now determined as of the date of the shelf takedown, rather than upon effectiveness of the registration statement. Section 11 liability for directors, officers who sign the registration statement, and "experts" continues to be determined at the registration statement effective date. If an expert provides a new report or opinion in an Exchange Act report or in connection with the takedown that would require a consent, however, there would be a new effective date for that expert.
2. The liability of security sellers for false and misleading statements (Section 12(a)(2)) is now based solely on information deemed to have been conveyed to the investor before or at the time of the security sale, rather than being based on information in the final prospectus.
3. Section 11 liability now applies to prospectus supplements.

For further reference see:

Securities Offering Reform

Securities Offering Reform Transition Questions and Answers

Securities Offering Reform Questions and Answers

These can be found on the SEC's Web site at www.sec.gov.

Speech by Joel K. Levine, *Associate Chief Accountant,* Division of Corporation Finance

Amendments to Accelerated Filer Definition and Filing Deadlines

Mr. Levine discussed proposed amendments to the accelerated filer definition and filing deadlines and indicated that the Commission would hold an open meeting to vote on these proposed amendments.

Editor's Note: On December 14, 2005, the SEC held the open meeting to which Mr. Levine referred. The balance of this section will describe the results of the Commission's deliberations.

At its December 14, 2005, meeting, the SEC amended the definition of "accelerated filer" by creating a new category, "**large accelerated filers**," for companies that have an aggregate worldwide market value[1] of $700 million or more and meet the other conditions in Exchange Act Rule 12b-2 that apply to accelerated filers (e.g., having previously filed at least one annual report). Accelerated filers other than large accelerated filers are those companies with an aggregate worldwide market value of at least $75 million but less than $700 million.

Also at the meeting, the SEC delayed by one additional year the final phase-in of Form 10-K filing deadlines for "large accelerated filers." Large accelerated filers will continue to be subject to the current 75-day deadline for Form 10-K for an additional year. Beginning with fiscal years ending on or after December 15, 2006, large accelerated filers will become subject to a 60-day deadline for Form 10-K.

Accelerated filers, other than large accelerated filers, will continue to be subject to the current 75-day deadline. The current Form 10-Q deadlines will be maintained for all filers. As such, the deadlines are as follows:

	Form 10-K Deadline	Form 10-Q Deadline
Large accelerated filers:		
• Fiscal years ending **prior to** December 15, 2006	75 days after year end	40 days after quarter end
• Fiscal years ending **on or after** December 15, 2006	60 days after year end	40 days after quarter end
Accelerated filers	75 days after year end	40 days after quarter end
Non-accelerated filers	90 days after year end	45 days after quarter end

Additionally, the amendments will ease some of the current restrictions on the exit of companies from accelerated filer status.

The final rule is available on the SEC's Web site, www.sec.gov.

[1] Aggregate worldwide market value is the market value of outstanding voting and nonvoting common equity held by non-affiliates and, for purposes of applying these amendments, should be calculated as of the last business day of the issuer's most recently completed second fiscal quarter.

Speech by Rachel Mincin, *Associate Chief Accountant*, Division of Corporation Finance

Disclosures About Off-Balance-Sheet Arrangements

In connection with the Sarbanes-Oxley Act, the Commission issued final rules in 2003 requiring disclosure about off-balance-sheet arrangements that management believes are reasonably likely to have a material effect on the registrant's financial position, results of operations, and cash flows. The rules include a definition of off-balance-sheet arrangements and require that the related disclosures be presented in a separately captioned section in MD&A.

The Sarbanes-Oxley Act also required the SEC to complete a study of filings by issuers to determine both (1) the extent of off-balance-sheet transactions, including assets, liabilities, leases, losses, and the use of special purpose entities; and (2) whether generally accepted accounting principles result in financial statements that reflect the economics of such off-balance-sheet transactions to investors in a transparent fashion.

The study was completed and submitted to the President of the United States and certain other components of the government in June 2005 (see *Heads Up*, June 23, 2005). For the study, the SEC staff analyzed data collected from the 2003 Form 10-K filings of a sample of 200 issuers, comprising the 100 largest issuers and 100 randomly selected issuers. At the Conference, Ms. Mincin presented a summary of the proportion of issuers that reported off-balance-sheet arrangements in MD&A:

Off-Balance-Sheet Arrangement	Large Issuers	Random Issuers
Guarantees	39%	4%
Retained Interest	14%	0%
Equity-Linked Derivatives	2%	1%
Variable Interest Entities	13%	1%

Ms. Mincin observed that a significant portion of issuers did not have a separately captioned off-balance-sheet arrangement section in MD&A and, for those that did, the data was often incomplete. Specific examples of transactions that were included in other sections of Form 10-K filings but were omitted from the off-balance-sheet arrangement section in MD&A include:

- Equity-linked derivatives,
- Retained interests in securitized assets,
- Interests in variable interest entities, and
- Guarantees.

Ms. Mincin emphasized that disclosures of off-balance-sheet arrangements need to include information necessary for an understanding of the arrangement and its material effects, including:

- Nature and business purpose of the arrangement,
- Importance of the arrangement,
- Financial impact of the arrangement and exposure to risk as a result of the arrangement, and
- Known events, demands, commitments, trends or uncertainties that affect availability or benefit of the arrangement.

Ms. Mincin also suggested the following best practices for disclosure of off-balance-sheet arrangements:

- Include descriptions that specifically address the company's particular circumstances and operations,
- Include cross references that clearly identify specific information in the footnotes and integrate the substance of the footnotes into MD&A, and
- When there are no material transactions that meet the Regulation S-K definition of an off-balance-sheet arrangement, clearly disclose that fact.

Speech by Sondra L. Stokes, *Associate Chief Accountant*, Division of Corporation Finance

Disclosure Controls and Procedures and Internal Control Over Financial Reporting

Ms. Stokes reminded the audience that all registrants are required to evaluate the effectiveness of disclosure controls and procedures on a quarterly basis in accordance with Item 307 of Regulation S-K in connection with management's certification requirements under Section 302 of the Sarbanes-Oxley Act of 2002. Once a registrant has completed its first annual assessment of the effectiveness of its internal control over financial reporting (ICFR), it is also required to make disclosure on a quarterly basis of material changes in ICFR. The requirements related to management's annual assessment of ICFR are in Item 308 of Regulation S-K and apply to (1) accelerated filers with fiscal years ending on or after November 15, 2004; (2) foreign private issuers who are accelerated filers with fiscal years ending on or after July 15, 2006; and (3) non-accelerated filers (including small businesses) with fiscal years ending on or after July 15, 2007.

In each quarterly filing on Form 10-Q in Item 4, *Controls and Procedures*, management must clearly state its conclusion as to whether disclosure controls and procedures are either (1) "effective" or (2) "ineffective" as of the end of the respective quarter, without any qualifying or alternative language. The SEC will request that a company amend its filing if it includes qualifying or alternative language in its conclusion on the effectiveness of disclosure controls and procedures. Examples of unacceptable language include phrases such as "effective except for," "effective except as disclosed below," or "adequate."

If, during the quarter, a company has identified the existence of a material weakness in ICFR that is not remediated by the end of the quarter, the registrant should (1) disclose the existence of such material weakness and (2) describe the nature of the material weakness, the impact on financial reporting and the control environment, and management's remediation plan. Ms. Stokes indicated that, while highly unlikely, it is possible that a registrant could conclude that disclosure controls and procedures are effective if a material weakness exists in ICFR. This is due to the substantial overlap between disclosure controls and procedures and ICFR. Ms. Stokes reaffirmed that when a material weakness exists in ICFR, management has a high hurdle to overcome before being able to conclude that disclosure controls and procedures are effective.

However, if management does conclude that disclosure controls and procedures are effective, notwithstanding the existence of a material weakness in ICFR, it is critical that the company clearly disclose the factors that it considered and the basis for reaching this conclusion. Ms. Stokes stated the disclosure should not be "boilerplate"; rather, it should reflect in detail the specific facts considered by the registrant.

Ms. Stokes stated that a material weakness in ICFR does not always exist when previously issued financial statements are restated for the correction of an error(s). A registrant should consider why the restatement was necessary and whether the restatement resulted from a material weakness in underlying controls. However, she acknowledged that a restatement of previously issued financial statements to reflect the correction of an error(s) is indicative of at least a significant deficiency and a "strong indicator" that a material weakness exists, as described in PCAOB Auditing Standard No. 2, *An Audit of Internal Control Performed in Conjunction With An Audit of Financial Statements.*

In the case of a restatement of previously issued financial statements to reflect the correction of an error(s), Ms. Stokes commented that the SEC's rules do not require a registrant to make a full reassessment of its report on internal control over financial reporting; the rules require the registrant to make only one assessment at its year-end balance sheet date.

Ms. Stokes noted that the registrant would have to address disclosure of the material weakness(es) in its Form 10-K/A in conjunction with its Regulation S-K, Item 307 and 308(c) disclosures. Item 307 disclosures might need to be changed to state that disclosure controls and procedures were not effective and Item 308(c) disclosures might need to be changed to state that a material weakness in internal control over financial reporting was identified subsequent to year end. In accordance with AICPA Codification of Statements of Auditing Standards, AU Section 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report," an auditor would need to issue a revised report on the registrant's internal control over financial reporting for inclusion in the Form 10-K/A. Ms. Stokes observed that, although the registrant is not required to reassess its report on internal control over financial reporting, it may elect to do so since the registrant would likely want an unqualified opinion on management's assessment of internal control over financial reporting from its auditors upon reissuance of the auditor's opinion. This would prompt the registrant to issue a revised management report on internal control over financial reporting.

Block Discounts

Ms. Stokes stated that, other than as permitted for certain specialized industries, available quoted market prices are evidence of the fair value of a financial instrument, and that using block discounts to determine fair value is not in accordance with GAAP. Taking a block discount refers to taking a discount from the quoted market price of a financial instrument when an entity's position in a traded security is so large that the entity believes it cannot be absorbed readily by the market (e.g., because the security is thinly traded).

Ms. Stokes referred to a registrant example involving company-issued preferred stock that was convertible into common. In estimating the fair value of its convertible preferred stock, the registrant took a block discount from the quoted market price of its common stock because the preferred stock was convertible into approximately 50 percent of the company's existing outstanding common stock and it believed its shares were thinly traded. The SEC staff objected to the use of the discount and believes that, other than as permitted for certain specialized industries, quoted market prices are generally the best evidence of fair value.

The use of quoted market prices versus block discounts is supported by paragraphs 5 and 58 of FASB Statement No. 107, *Disclosures About Fair Value of Financial Instruments*, and by paragraph 3(a) of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. The prohibition on using block discounts to estimate fair value is supported by paragraph 6 of Statement 107 and footnote 3 of EITF Issue No. 98-5, "Accounting for Convertible Securities With Beneficial Conversion Features or Contingently Adjustable Conversion Ratios."

Warrants Issued to Non-Employees

Ms. Stokes explained that warrants issued to nonemployees differ from employee share options in that they typically do not contain transfer restrictions and are normally subject to immediate exercise. These differences impact how the fair values of warrants granted to nonemployees and share options granted to employees should be estimated when using a Black-Scholes model. She then referred to footnote 7 of SEC Staff Accounting Bulletin No. 107, *Share-Based Payment*, which states the following, in part:

> If these features (i.e. nontransferability, nonhedgability and the potential truncation of the contractual term) were not present in a nonemployee share option arrangement, the use of an **expected term** assumption shorter than the **contractual term** would generally not be appropriate in estimating the fair value of the nonemployee share option. [Emphasis added]

Accordingly, Ms. Stokes stated that if warrants issued to non-employees are valued using a Black-Scholes model, issuers should use the contractual term in the calculation, not the expected term if it is shorter.

Speeches by Jeff Naumann, *Enabling Technology Specialist*, Office of the Chief Accountant; Keith Wilson, *Associate Chief Auditor*, PCAOB; John Stantial, United Technologies; John Philip, Infosys Technologies Limited; and Wayne Harding, XBRL US

XBRL and the SEC Voluntary Filing Program

In February, the SEC adopted final rules enabling registrants to voluntarily submit supplemental financial information using the eXtensible Business Reporting Language (XBRL) format in addition to filing its financial information in HTML or ASCII format, as currently required. XBRL is a data tagging language for enhancing financial reporting. Tagging provides greater context to data through standard definitions that turn text-based information, such as the filings currently contained in the Commission's EDGAR system, into documents that can be retrieved, searched, and analyzed through automated means. Data tags describe information such as items included in financial statements. This enables investors and other marketplace participants to analyze data from different sources and allows for the automatic exchange of financial information across various software platforms, including Web services. The SEC will use the tagged data to assist in its review of financial statements and disclosures and provide the ability to screen filings when submitted in order to manage the review process in a risk-based manner.

The SEC encourages, but does not require, registrants to participate in the program. The XBRL documents are furnished, rather than filed, as Exhibit 100 to Exchange Act and Investment Company Act filings. While there is no deadline for XBRL submission, the SEC encourages it either with the official filing or shortly thereafter. Registrants participating in the program are free to stop and start at any time.

Volunteers must provide disclosures about the XBRL documents that (1) include cautionary language that the submission should not be relied upon for investing decisions since the document is furnished to the SEC and not filed and (2) disclose that the information is "unaudited" or "unreviewed." XBRL documents must contain at least one of the following: (1) a complete set of financial statements (footnotes and schedules may be omitted); (2) earnings information from a Form 8-K or Form 6-K; or (3) financial highlights or condensed financial information. Optional content may include audit opinions, interim review reports, reports of management on the financial statements, certifications, and MD&A.

Editor's Note: The final rule is available on the SEC's Web site. For more information on the XBRL program, including links to the final rule, the filer manual, and frequently asked questions about the XBRL program, see the SEC's Web site at www.sec.gov.

Assurance reporting is not a required part of the XBRL program; however, in May 2005, the PCAOB issued a list of frequently asked questions and answers regarding the application of attest standards, engagement procedures, and engagement reporting. These frequently asked questions can be viewed at the PCAOB's Web site, www.pcaobus.org.

Speech by Herbert S. Wander, *Co-chair*, SEC Advisory Committee on Smaller Public Companies

Smaller Public Company Issues

The SEC Advisory Committee on Smaller Public Companies was formed by SEC Chairman William H. Donaldson in December 2004 to examine the impact of the Sarbanes-Oxley Act on smaller public companies and make recommendations to the Commission. The Advisory Committee is composed of four subcommittees that deal with (1) accounting standards, (2) capital formation, (3) corporate governance and disclosure and, (4) internal controls .

Mr. Wander reported key activities of the four subcommittees and highlighted some of the recommendations that may come out of these subcommittees. Information regarding Advisory Committee activities can be found in the Small Business section of the SEC's Web site at www.sec.gov.

Speeches by Craig C. Olinger, *Deputy Chief Accountant*, Division of Corporation Finance and Susan Koski-Grafer, *Senior Associate Chief Accountant*, Office of the Chief Accountant

The presenters discussed new rules, issues related to the first-time application of IFRS, several reporting issues, and international regulatory developments.

Recent Rules Affecting Foreign Private Issuers

First-Time Application of IFRS Rule

A number of countries, led by those in Europe, have mandated the use of International Financial Reporting Standards (IFRS) beginning in 2005. As a result, several hundred foreign private issuers will be adopting IFRS for the first time in their 2005 financial statements to be filed with the SEC next year. The SEC staff has indicated that over the next several months it will be focused on the implementation of IFRS by these foreign private issuers.

Omission of Financial Statements for the Third Year

To eliminate certain inconsistencies between IFRS and SEC rules and regulations, and to address other issues related to the first-time application of IFRS for foreign private issuers, the Commission issued *First-time Application of International Financial Reporting Standards* (Release 33-8567, April 12, 2005) (the Rule).

The Rule permits eligible foreign private issuers, for their first year of reporting under IFRS, to file only two years of audited financial statements (versus three, as otherwise required under Regulation S-X) prepared in accordance with IFRS, with appropriate related disclosure. All years presented using IFRS must be reconciled to US GAAP.

This two-year accommodation is available to registrants that adopt IFRS by fiscal year 2007 and applies to all annual reports on Form 20-F and to 1933 and 1934 Act Registration Statements. The two-year accommodation is available for financial statements of the registrant and for the financial statements of other "foreign businesses" included in the registrant's filings (e.g., financial statements of (1) acquired businesses provided under Regulation S-X Rule 3-05, (2) equity method investees under Rule 3-09, (3) guarantors under Rule 3-10, (4) collateral entities under Rule 3-16, and (5) target companies in a business combination filed in a Form F-4, Form S-4, or proxy statement).

A registrant may include "previous" GAAP (i.e., the GAAP used by the issuer immediately prior to the adoption of IFRS) financial information, but is not required to do so. However, if previous GAAP information is included, there must be appropriate cautionary language about the lack of comparability with IFRS; side-by-side presentation with IFRS is **prohibited**.

"EU GAAP"

The Rule contemplates full compliance with IFRS; it requires an unreserved and explicit statement of compliance and the auditors' report must be unqualified. An exception to full compliance exists for registrants that prepare financial statements in accordance with IFRS, as adopted by the European Union (referred to as "EU GAAP" in the Rule) as long as the financial statements include:

- Audited reconciliations from EU GAAP to IFRS as published by IASB, including any additional required disclosures; and
- Audited reconciliations to US GAAP.

Disclosures

All first-time adopters are required to disclose their transition elections under IFRS 1, *First-time Adoption of International Financial Reporting Standards*, as well as the initial reconciliation of previous GAAP to IFRS. The staff emphasized that their reviews during the 2005–2006 implementation period would focus on faithful and consistent application of IFRS, and the completeness of the US GAAP reconciliation. The staff emphasized the importance of transparent disclosure of reconciling items — especially in order to help investors understand those reconciling items arising from the transitional exemptions from IFRS allowed under IFRS 1 (e.g., elimination of any foreign currency cumulated translation adjustments) versus ongoing differences between IFRS and US GAAP.

The Rule addresses not only the financial statements, but other disclosures of Form 20-F and other foreign registration statements as well. Selected Financial Data, for example, should reflect data from the financial statements, and accordingly should include:

- Two years of IFRS data (expanding to five years over future periods); and
- Five years of US GAAP (unless a shorter period is already permitted).

Selected Financial Data disclosures prepared on a basis of previous GAAP are permitted, but not required. Where issuers elect to include or incorporate previous GAAP financial information they must prominently disclose that the filing contains financial information based on the issuer's previous GAAP, which is not comparable to IFRS. The SEC did not specify particular language to be used as they believe it may vary depending on the use made of the previous GAAP information.

The Rule also allows other disclosures to be based on two years of IFRS data (with disclosure of US GAAP amounts, if material). These include (Item numbers refer to Form 20-F):

- Description of the Business (Item 4),
- Operating and Financial Review and MD&A (Item 5),
- Market Risk Disclosures (Item 11), and
- Industry Guide Data (previous GAAP or US GAAP for previous years).

Interim Financial Information in Registration Statements Effective Less Than Nine Months After Year End

Under existing rules, interim financial statements required to be included in Form 20-F registration statements *only because they have been published in the home country* (see Form 20-F, Item 8.A.5) do not need to be reconciled to US GAAP unless they are prepared on a different basis of accounting than those in the most recent annual financial statements. The Rule provides an accommodation when the change in the basis of accounting is to adopt IFRS. In these cases, a reconciliation from IFRS to US GAAP is not required. The staff noted that registrants need to include appropriate disclosures about the lack of comparability between the most recent annual financial statements prepared on a previous GAAP basis and the interim IFRS financial statements. The Rule also acknowledges that an issuer may be unable to comply fully with IFRS for interim financial information during the transition year and that the issuer should provide appropriate cautionary language in this regard.

Interim Financial Information in Registration Statements Effective More Than Nine Months After Year End

When interim financial statements are required in a Form 20-F registration statement effective more than nine months after year end, the rule provides the following four options during the transition year:

- Previous GAAP option — include three years of audited annual previous GAAP and current comparative unaudited interim previous GAAP financial statements, all reconciled to US GAAP;
- IFRS option — two years of audited annual IFRS and current comparative unaudited interim IFRS GAAP financial statements, all reconciled to US GAAP;
- US GAAP condensed option — three years audited previous GAAP financial statements, current comparative unaudited interim IFRS GAAP financial statements, all reconciled to US GAAP and condensed US GAAP balance sheet and income statement for most recent fiscal year and current and comparative interim period;
- Case-by-case option — the staff is open to consultation if registrants believe they are either unable to comply with the other three options and believe that alternative meaningful combinations of previous GAAP, IFRS, and US GAAP could be substituted.

Retroactive Application of Improved IFRS Standards in Registration Statements

Where a registrant adopted IFRS prior to January 1, 2005, and later adopts the Improvement Project standards, its financial statements for periods prior to adoption of the improved standards may require restatement if reissued. This arises because many of the Improvement Project standards require retrospective application, and Item 5(b)(1)(ii) of Form F-3, *Material Changes*, states, in part: "include restated financial statements if there has been a change in accounting principles…where such change…requires a material retroactive restatement of the financial statements." While this requirement is articulated in the instructions to Form F-3, the staff indicated that they will be applying it to **all** registration statements.

Implementation Questions

A number of IFRS implementation issues were discussed at the May 2005, AICPA International Practices Task Force meeting. Affected registrants and their auditors are advised by the SEC staff to read the highlights of that meeting. Items discussed include:

- Eligibility,
- Registration statements in the transition year,
- Exceptions mandated or permitted by IFRS No. 1,
- EU GAAP matters,
- Other disclosures, and
- Furnished information.

Non-GAAP Measures Rule and IFRS Financial Information

The staff clarified that rules regarding the use of non-GAAP financial measures is **not** intended to prohibit additional useful captions and subtotals that are consistent with IFRS reporting. The staff cited the presentation of operating results articulated in IAS 1, paragraph BC 13 as an example. The staff will evaluate compliance with IFRS and challenge the purpose and usefulness of unusual/additional measures and presentations that appear to be misleading or inconsistent with IFRS. Where the income statement presentation is considered acceptable under IFRS, additional disclosure under the non-GAAP measures rule generally would not be required.

New Rules on Shell Companies

The staff noted that the new shell company rules (Release No. 33-8587, *Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies*), also apply to foreign private issuers. Upon completion of a merger or reorganization with an operating company, a foreign private issuer shell company must file a Form 20-F **within four business days**. This is a significant acceleration of the due date.

Securities Offering Reform Rule

The staff clarified that while a foreign private issuer meeting the necessary conditions can be considered a "well known seasoned issuer," a filer utilizing the Multi-Jurisdictional Disclosure System ("MJDS") may not be considered a "well known seasoned issuer."

Reporting Issues

Internal Controls Over Financial Reporting Under Section 404 of the Sarbanes-Oxley Act

Accelerated Filer Definition

Mr. Olinger noted that the accelerated filer definition impacts the revised compliance dates for foreign private issuers for internal control reporting under Section 404. Accelerated filers are required to comply with Section 404 for the first fiscal year ending after July 15, 2006. Non-accelerated filers must comply for the first fiscal year ending after July 15, 2007. Mr. Olinger indicated that for December 31 year-end companies, the market capitalization test should be completed as of June 30, with all other tests completed as of December 31.

Applicability of Sarbanes-Oxley 404 to Interim Information

The staff indicated that because a foreign private issuer is not required to file interim financial statements, management's report on internal control over financial reporting only needs to cover those periods that are **filed** with the SEC (thus, closing procedures over interim periods not filed with the SEC need not be reported on).

"Bifurcation" of Sarbanes-Oxley 404 Reporting

The SEC staff is still considering whether it would be appropriate for management to conclude, in its assertion on internal control over financial reporting, that the controls surrounding home-country GAAP financial statements were effective, but that the controls surrounding the reconciliation to US GAAP were not effective. The staff is also considering the effect of this situation on the auditor's attestation under PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*.

Disclosure Controls and Procedures

The staff noted that foreign private issuers currently are subject to the Disclosure Controls and Procedures reporting requirements of Regulation S-K Item 307 and must consider the impact of restatements on previous control effectiveness disclosures. In cases where material weaknesses are found, the staff expects that careful consideration be given to the need for disclosure under Item 15, *Controls and Procedures*, of Form 20-F.

Guarantor Information

Mr. Olinger indicated that regardless of whether a registrant applies home-country GAAP or IFRS, it must reconcile the condensed consolidating information required under Article 3-10 of Regulation S-X with US GAAP. He clarified that the reconciliation should be prepared with a level of detail consistent with Item 17 of Form 20-F to aid investors in evaluating the sufficiency of the guarantees.

The SEC staff also believes condensed consolidating cash flow statement data presented under Article 3-10 should not reflect "price-level adjusted" information. The staff will allow registrants to prospectively apply this guidance beginning with fiscal years ending December 31, 2005.

International Regulatory Developments

Ms. Koski-Grafer indicated that the International Organization of Securities Commissions (IOSCO) has a project underway to promote consistent application of IFRS across the globe. It involves the creation of a database to which regulators will contribute information on regulatory decisions relating to the interpretation of IFRS.

Participating regulators are expected to use their best efforts to refer to this database when making decisions and to contribute information. Contribution of information is not required, but it is encouraged. Conflicting decisions on the application of IFRS will be referred to the IASB and its interpretation committee. IOSCO anticipates that the database will be operational by the second half of 2006. At this stage it is not intended for the catalogue of decisions to be publicly accessible.

Ms. Koski-Grafer indicated that the Public Interest Oversight Board (PIOB), established in February 2005 by the International Auditing and Assurance Standards Board (IAASB), will oversee the work of the International Federation of Accountants' (IFAC) auditing, ethics, and education standards setting committees and its Member Body Compliance Program. The stated objective of the PIOB is to help ensure that IFAC's standard-setting activities reflect the public interest and are fully transparent to those affected by the standards.

Speeches by Charles D. Niemeier, *Board Member*, Public Company Accounting Oversight Board and Douglas R. Carmichael, *Chief Auditor*, Public Company Accounting Oversight Board

PCAOB Developments

Mr. Niemeier emphasized that the accounting profession is currently in the spotlight and that many outside the profession who were previously unaware of the auditors' role now have awakened to the significance of the profession to the capital markets. He acknowledged that four years ago the profession was in crisis, but that the profession has responded by admitting mistakes and making the changes that the Sarbanes-Oxley Act required it to make. In his view, the increased focus on the profession makes it critical that the profession communicate to the public in a way that helps people to better understand what auditors do and why.

Mr. Niemeier commended the FASB and the SEC for their commitment to reducing the complexity of financial reporting. However, he expressed his view that effecting change will take a collaborative effort from all interested parties. He encouraged everyone involved to contribute.

Mr. Niemeier noted that while professional judgment is at the root of the profession, CPAs have a tendency instead to rely on rules. He stated that "there is a simple truth that there is no rule against doing the right thing," and continued by saying that “often we know what the right thing is” and that we have a professional responsibility to “do the right thing” regardless of what the rules will allow.

PCAOB Standard Setting Update

Mr. Carmichael focused on three areas: (1) standard setting, (2) internal control over financial reporting, and (3) fraud detection, which are discussed below.

Standard Setting

Mr. Carmichael emphasized that the PCAOB has made significant progress, citing increased staffing of highly qualified professionals at the PCAOB and the establishment of solid working relations with the SEC and an effective process whereby the PCAOB can promulgate authoritative guidance through PCAOB Staff Questions and Answers.

Mr. Carmichael stated that the PCAOB is in the process of developing Staff Questions and Answers on the following topics:

- Predecessor and successor auditor situations when an issuer is required to use the retrospective application method of reporting a change in accounting principle or is required to restate financial statements to correct an error and the predecessor auditor is no longer independent of the issuer. The answers will provide a means whereby the successor auditor will be able to report only on the adjustments, presuming the predecessor auditor is willing to reissue its original report.
- Auditing of Statement 123(R) Assumptions — The answers will provide detailed guidance to auditors related to the application of AICPA Statement of Auditing Standards No. 101 (AU Section 328), *Auditing Fair Value Measurements and Disclosures*, when auditing the assumptions used in fair value measurements required by FASB Statement No. 123 (revised 2004), *Share-Based Payment* (e.g., volatility and expected term).

Internal Control Over Financial Reporting

Mr. Carmichael stated that the PCAOB, pursuant to Rule 4010, recently issued its "Report on the Initial Implementation of Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements.*" Under Rule 4010, the PCAOB may publish summaries, compilations, or general reports concerning the results of its various inspections, provided that no such published report may identify the firm or firms to which any quality control criticisms in the report relate. These reports also may include information that was not gathered during the inspection process.

Mr. Carmichael stated that the report includes the following observations in the areas of efficiency and effectiveness, as follows:

Efficiency

- Due primarily to externally imposed time constraints, auditors were unable to fully integrate the financial statement and internal control components in their first-year audits under Auditing Standard 2.
- Auditors, to varying degrees, approached the audit of internal control from the bottom up, rather than top down.
- The nature, timing, and extent of the auditors' testing were not fully altered to reflect the level of risk assessed within a given area.
- A significant number of engagement teams chose not to use a single transaction for their walkthroughs, but rather subjected multiple transactions from different parts of the process to their walkthrough procedures.
- Auditors did not fully use the work of others to the extent that Auditing Standard 2 allows.

Effectiveness

- Auditors identified control deficiencies but did not sufficiently evaluate the adequacy of compensating controls on a timely basis.
- In several instances, auditors had not adequately focused on the period-end financial reporting process and had not identified and tested sufficient controls over financial statement presentation and disclosure.
- In some cases, the report noted that higher-risk areas should have received more attention than they did. Specifically, the PCAOB believes that, given the high degree of risk, the period-end financial reporting process is always a significant process and that significant attention to this process is necessary in virtually all audits.
- In some walkthroughs, auditors did not ask sufficiently probing questions to be able to identify the points at which a necessary control was missing or inadequate.
- After identifying control deficiencies, auditors did not always re-evaluate the original risk assessments used in planning the audit of internal control.
- Auditors did not always determine the effect of control deficiencies on the nature, timing, and extent of substantive procedures to be performed as part of the financial statement audit.

In addition to these observations, the report clarifies that the objective of an audit of internal control over financial reporting is to obtain reasonable assurance that no material weaknesses exist. However, when planning the audit, the auditor must consider the fact that deficiencies, either individually or in the aggregate, may represent a material weakness. The standard does not require the auditor to design the audit to identify all deficiencies or significant deficiencies.

Fraud Detection

Mr. Carmichael stated that the PCAOB is in the process of developing its next 4010 report that will address implementation of AICPA Statement of Auditing Standards No. 99 (AU Section 316), *Consideration of Fraud in a Financial Statement Audit*. He is concerned that auditors are not taking fraud detection seriously enough in the performance of audits. Although the report is not finalized and therefore subject to change, he stated that the following issues might be addressed:

- *Fraud Brainstorming Session* — Engagement teams should determine that the right people are involved in the brainstorming sessions.
- *Fraud Risk Factors* — When risks are identified, it is the expectation of the PCAOB that an appropriate response will be identified and the audit documentation would reflect the fact that the approach has changed in response to the risk.
- *Extent of Testing* — When the risk of fraud increases, the PCAOB expects that the work performed by the auditor in these areas will increase (e.g., increased sample sizes for confirmations).
- *Error Evaluation* — Qualitative factors should be considered when evaluating all errors detected during the audit to determine whether the errors are intentional or the result of management bias, specifically when the errors are the result of departures from generally accepted accounting principles.
- *Journal Entry Testing* — Auditors need to determine that selections are made from a complete population. In addition, journal entries should not be excluded from the sample based on quantitative thresholds alone (e.g., do not exclude all journal entries below an established threshold).
- *Senior Management Involvement* — The PCAOB expects that senior members of the engagement team will be extensively involved in the fraud consideration process in an audit. He advised the avoidance of the "checklist approach," which results in senior members of the engagement team receiving less information upon which to evaluate decisions.

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