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In This Issue:

- Introduction
- Keynote Speakers
- Summaries of Other Speeches and Comments
- Appendix A: Glossary of Standards
- Appendix B: Topical Index

Members of the following Deloitte teams contributed to this issue of *Heads Up*: Accounting Standards and Communications, Audit and Assurance Services, Independence, Quality Assurance, and SEC Services. To our colleagues at Deloitte, our clients, and our other friends, we wish each of you a joyous and peace-filled holiday season and a happy new year.

Let Us Know, Let Us Know, Let Us Know!

Highlights of the 2008 AICPA National Conference on Current SEC and PCAOB Developments

by Deloitte & Touche LLP's National Office Departments of Professional Practice

Introduction

Shortly before the holidays, the AICPA holds its annual National Conference on Current SEC and PCAOB Developments (the "Conference"). During the Conference, the SEC, PCAOB, FASB, IASB, and others provide financial professionals with updates on new developments, regulations, and current priorities — just in time for the annual reporting season.

This issue of *Heads Up* extracts key insights from nearly 26 hours of material at the 2008 Conference. It focuses on experts' views on topics including accounting and disclosure issues related to the troubled credit markets, use of fair value, goodwill impairments, and the release of the Division of Corporation Finance *Financial Reporting Manual* on the SEC's Web site. We have also included links to information available elsewhere — for example, details on new or proposed accounting guidance are on the FASB's Web site at www.fasb.org.

To locate the topics that interest you, use the topical index in Appendix B or the table on page 6. Then, click a speaker's name to jump to a speech summary.

Keynote Speakers

Speakers
Christopher Cox, *Chairman*, Securities and Exchange Commission
Conrad W. Hewitt, *Chief Accountant*, Securities and Exchange Commission
Robert H. Herz, *Chairman*, Financial Accounting Standards Board
Mark W. Olson, *Chairman*, Public Company Accounting Oversight Board
Sir David Tweedie, *Chairman*, International Accounting Standards Board
Cynthia M. Fornelli, *Executive Director*, Center for Audit Quality

Conference Themes

As expected, one of the recurring themes at this year's conference was the economic crisis and the pressure it is putting on multiple aspects of the financial reporting system. A related theme that emerged was that in this troubled economic environment, we need to place even greater emphasis on ensuring the independence of the standard setters in the United States and internationally.

The Current Crisis and Lessons to Be Learned

Focusing on the current economic crisis, SEC Chairman Christopher Cox started his remarks by reflecting on past market dislocations precipitated by a credit crisis (America's Panic of 1884) or an economic downturn (Great Depression). He noted that during these periods, "much of the blame [for the market turmoil] was directed at members of the accounting profession." However, he stated, "In hindsight, we know that the fault did not lie so much with the practitioners of accounting, but with the lack of objective and widely-accepted accounting standards. In the absence of industry-wide standards, accountants were forced to make ad hoc determinations across a range of business situations." He noted that "this history is directly relevant to us today [since] accounting standard setting is at the center of the debate over how banks and financial firms got into — and how they can get out of — the current financial turmoil." However, FASB Chairman Robert Herz noted an important difference between the current crisis and some past crises. He stated that "this time the crisis has been a global one, starting with the collapse of the U.S. housing market, leading to a credit crisis here and abroad, then to a full[y] fledged crisis in the global financial markets, and now to a global recession."

The Importance of an Independent Accounting Standard-Setting Body

Chairman Cox noted that one step taken to address the "accounting improvisation" associated with the Great Depression was the establishment of the AICPA in 1939 as an independent rulemaking body to establish industry-wide accounting standards, particularly on contentious issues. He noted that the reasons for originally creating a nongovernmental body after the Great Depression are still relevant today: "to be fair and objective, based on expert analysis and judgment, and free of both political and business influence."

He noted that as we respond to the challenges associated with the current market, the independence of the standard-setting process must be protected. This independence is critical to maintaining investor confidence in financial reporting.

> Accounting standards should not be viewed as a fiscal policy tool to stimulate or moderate economic growth, but rather as a means of producing neutral and objective measurements of the financial performance of public companies. Accounting standards aren't just another financial rudder to be pulled when the economic ship drifts in the wrong direction. Instead they are the rivets in the hull, and you risk the integrity of the entire economy by removing them.
>
> — SEC Chairman Christopher Cox

Keynote speakers also observed that due process is a critical element of standard setting. Due process helps ensure that a balanced view is heard and that competing interests are considered so that the standards issued provide financial statement users with information that, in Chairman Cox's words, is "transparent, credible, and comparable."

Several keynote speakers focused on other topics related to the major themes, such as the need for changes in the regulatory structure, the role of fair value in financial reporting, and other financial reporting issues. They also provided some insight into their visions for the future.

Calls for Regulatory Changes

Keynote speakers discussed the need to update the U.S. regulatory structure. PCAOB Chairman Mark Olson noted that the current financial crisis gives Congress and the new presidential administration a unique opportunity "to strengthen our financial system and rethink the U.S. financial regulatory framework." Chairman Olson and Chairman Herz both noted that the current regulatory framework is fragmented and inefficient. Cynthia Fornelli noted that this "patchwork approach" to regulation needs to be eliminated. Chairman Herz noted that certain areas of the financial services and capital markets are also subject to minimal or no regulations and that "[i]n some cases, self-regulation appears to have been tantamount to no regulation."

Chairman Olson expressed support for a regulatory structure that includes a "supervisory approach" (e.g., one that uses inspections to identify and remediate deficiencies), rather than a pure regulatory approach (e.g., one that only verifies compliance with regulations), to both financial institutions and auditor oversight and that focuses on enterprise-wide risk management.

Chairman Herz noted that "another key lesson learned and relearned is that sound markets require a proper infrastructure to facilitate the flow of information, ascertain price discovery, support the necessary clearing mechanisms, and allow for informed and knowledgeable market participants. Effective oversight and regulation are also key ingredients of sound markets, as are the exercise of appropriate due diligence by investors and proper risk management processes by financial institutions."

Role of Fair Value

Keynote speakers noted that some market participants think that the fair value accounting standards have caused or contributed to the current market turmoil, while other market participants believe that these same standards have increased transparency and resulted in timely recognition of the problems. Most of the keynote speakers seemed to believe that fair value accounting standards did not cause the current economic crisis and that most investors support fair value accounting. Chairman Herz stated, "Most investors have been clear; they want to see the current fair values of a company's financial assets. They believe it is the appropriate method of accounting for such items and preferable to the current complex mixed attribute accounting for financial assets, and they generally applaud the added transparency provided by the new disclosures under FAS 157 (and indeed would like some additional disclosures like ranges and sensitivities)."

However, keynote speakers acknowledged the need for improvements to, and increased guidance on applying, the fair value standards, particularly guidance on measuring fair value in illiquid markets. Chairman Cox provided an update on the SEC's initiatives to address fair value accounting. He noted that the SEC has been working with the FASB staff to provide guidance on and clarifications for fair value measurements.

Study on Mark-to-Market Accounting

Chairman Cox noted that the SEC is conducting a study on mark-to-market accounting as mandated by Congress's Emergency Economic Stabilization Act. This study is one of the actions the SEC is taking to determine whether accounting standards, in particular Statement 157,[1] caused or contributed to the current economic crisis. The SEC must submit the results of the study to the Secretary of the Treasury and the Board of Governors of the Federal Reserve System by January 2, 2009.

The Study's Areas of Focus Include:

1. Effects of Statement 157 on a financial institution's balance sheet.
2. Impact of accounting standards on bank failures.
3. Impact of accounting standards on the quality of information available to investors.
4. Whether modification to the accounting standards is prudent and feasible.
5. Alternative accounting standards to Statement 157.
6. Process for developing accounting standards.

In their remarks, Chairman Cox and James L. Kroeker, deputy chief accountant in the SEC's Office of the Chief Accountant, shared the study's preliminary findings, which are based on roundtables held and input received in response to the SEC's request for comment on the study.

The preliminary findings include the following:

- The majority of a financial institution's investments consist of loans and available-for-sale securities that are subject to other-than-temporary impairment analyses, not investments that are marked to market through earnings.
- Improvements to accounting standards related to impairment of securities are warranted.
- "[M]ost investors, and many others, agree that fair value is a meaningful and transparent measure of an investment for financial reporting purposes."
- "[R]obust best practice guidance [must be developed] for auditors and preparers — particularly for fair value measurements of securities traded in inactive or illiquid markets."
- More needs to be done to stress the importance of an environment in which reasonable judgments are both developed and respected.

Editor's Note: For more information about the SEC's mark-to-market accounting study, see the SEC's Web site. Also see Mr. Kroeker's speech at the Conference.

[1] The full title of each standard referenced in the *Heads Up* appears in Appendix A: Glossary of Standards.

Fair Value Challenges

Chairman Herz acknowledged that there are issues with applying fair value, "particularly in illiquid markets, and for the highly complex securities and derivatives," but then went on to state that even given these issues, fair value should be used for reporting and it should be "supplemented with useful disclosures."

Chairman Herz noted that (1) "the use of fair value in financial reporting is hardly new," and (2) "the idea that in down markets assets should be written down to lower of cost or market or lower of cost or net realizable value, has been a fundamental concept in accounting for a century or more." However, in the current market, there are more financial assets, for which there was previously an active market, that are experiencing losses and that are illiquid. Thus, it is now necessary to use unobservable inputs for an increased number of financial assets when measuring fair value, which has made fair value measurement more difficult and complex. He highlighted the SEC and FASB's recent guidance addressing the valuation of financial assets in inactive markets and the global roundtables conducted with the IASB to obtain input on what other actions are necessary to address fair value reporting challenges.

Editor's Note: On October 10, 2008, the FASB issued FSP FAS 157-3, which provides guidance on determining the fair value of financial assets in an inactive market. See Deloitte's October 13, 2008, *Heads Up*, FASB Issues Guidance on Measuring Fair Value of Financial Assets in an Inactive Market.

On September 30, 2008, the SEC's Office of the Chief Accountant, in coordination with FASB staff, issued a press release that provides clarifications related to fair value measurements.

Chairman Olson noted that there are also audit challenges associated with fair value measurements and that PCAOB inspectors will focus on this area in their reviews of 2008 financial statement audits.

Editor's Note: On December 10, 2007, the PCAOB issued Staff Audit Practice Alert No. 2, which addresses four topics:

- Auditing fair value measurements.
- Classification of fair value measurements within the fair value hierarchy established by Statement 157.
- The use of specialists in fair value measurements.
- The use of pricing services in fair value measurements.

Other Issues Stemming From the Credit Crisis

Chairman Olson identified a number of other areas that auditors must focus on and that will be subject to increased PCAOB inspector review in light of the current market conditions.

- Other-than-temporary impairments — auditors' considerations should include "management's intent and ability to hold a security to recovery, the anticipated recovery period, and the need to quantify an impairment."
- Valuation issues — accounts receivable, inventory, deferred taxes, and goodwill.
- Going-concern assessments.
- Responses to increased risk of fraud because of earnings pressures on management.

Visions for the Future

Global Set of Accounting Standards

Chairman Cox noted that the current global market turmoil has established the importance of financial disclosure and transparency globally. A key element to improving investors' confidence is to provide them with the ability to compare a company's disclosures without regard to the country in which the company is domiciled. He highlighted the SEC's recent issuance of a proposed "roadmap" for use of IFRSs by U.S. public companies.

Chairman Cox believes that for IFRSs to be the single set of high-quality accounting standards, they must:

- Be written with the investor's interests in mind. This must be their primary purpose.
- Be created as part of a transparent accounting standard-setting process, with open due process.

- Be unbiased accounting standards "that foster investor confidence and transparency."
- Be part of a standard-setting process that involves all stakeholders.

He noted that global accounting standards are in the best interest of investors as long as the process creating them is "world-class."

Editor's Note: For additional information on the roadmap, see Deloitte's November 17, 2008, *Heads Up*, SEC Issues Proposed IFRS Roadmap.

Standard Setting

Chairman Cox, Chairman Herz, and IASB Chairman Sir David Tweedie discussed near-term standard-setting projects. They indicated that these projects are largely driven by the need to update and amend certain standards as a result of issues stemming from the economic crisis, including fair value and consolidation of off-balance-sheet entities. Sir David Tweedie noted the following projects have become a higher priority because of the economic crisis: (1) simplifying hedge accounting, (2) consolidation accounting, (3) derecognition of assets and liabilities, and (4) fair value measurement.

Sir David Tweedie noted that the IASB's goal is to have a high-quality set of standards that are rooted within a conceptual framework. He pointed out that principles-based standards involve no exceptions, have core principles and objectives, are not inconsistent, are tied to the conceptual framework, allow judgment, and provide minimal incremental interpretive guidance.

Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury

Chairman Olson noted in his remarks that the PCAOB is reviewing recommendations included in the report recently issued by the Department of the Treasury's Advisory Committee on the Audit Profession. In particular, the Board will be considering (1) "a fresh look at the auditor's report," (2) the establishment of a national fraud center, (3) reporting transparency, and (4) identification of "indicators of audit quality."

Editor's Note: On October 6, 2008, the Department of the Treasury's Advisory Committee on the Audit Profession issued the Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury.

Summaries of Other Speeches and Comments

2008 AICPA National Conference on Current SEC and PCAOB Developments

Speakers and Topics

To see details, turn to the speech summaries or click a speaker's name below. Links to additional reference materials appear throughout the speech summaries.

ACCOUNTING MATTERS		
Speaker	**Topics Covered**	**Affects**
Adam Brown, *Professional Accounting Fellow*, Office of the Chief Accountant of the SEC	• Impairment of long-lived assets held for sale under Statement 144 • Measurement of liability-classified share-based payment awards • Contracts indexed to a company's own stock	Entities that have long-lived assets held for sale Entities anticipating an IPO that have share-based awards recorded as a liability Entities that issue equity-linked financial instruments (embedded or freestanding)
Muneera Carr, *Professional Accounting Fellow*, Office of the Chief Accountant of the SEC	• Fair value measurements	Entities with assets measured at fair value
Robert G. Fox III, *Professional Accounting Fellow*, Office of the Chief Accountant of the SEC	• Professional judgment • Goodwill impairment • Push-down of debt under SAB Topic 5.J	All entities Entities with goodwill SEC registrants with acquisition-related debt
Steven C. Jacobs, *Associate Chief Accountant*, Division of Corporation Finance of the SEC	• Events and circumstances triggering goodwill impairment testing • Goodwill impairment disclosures • Valuation allowances for deferred tax assets • Repatriation of foreign earnings	Entities with goodwill Entities with deferred tax assets Entities that intend to repatriate, or have repatriated, foreign earnings
Robert B. Malhotra, *Professional Accounting Fellow*, Office of the Chief Accountant of the SEC	• Substantive kick-out rights • Related-party considerations in applying Interpretation 46(R) • Distributions from equity method investees	Holders or potential holders of variable interests Equity method investors
Russell Golden, *Technical Director*, FASB James L. Kroeker, *Deputy Chief Accountant*, Office of the Chief Accountant of the SEC Panel Discussion on Technical Issues Panel Discussion on Business Combinations Valuation Perspectives on Recent Accounting Issues	• Recently issued U.S. GAAP accounting standards • FASB standard-setting activities expected in the near future	All entities

Speaker	Topics Covered	Affects
James Leisenring, *Member*, IASB	• IFRSs and convergence projects with the FASB	Preparers, auditors, and users of IFRS financial statements
SEC MATTERS		
Speaker	**Topics Covered**	**Affects**
John W. White, *Director*, Division of Corporation Finance of the SEC	• The market crisis and the role of the Division of Corporation Finance • Enhancing transparency: how the Division of Corporation Finance interacts with the public	SEC registrants
Wayne E. Carnall, *Chief Accountant*, Division of Corporation Finance of the SEC Craig C. Olinger, *Deputy Chief Accountant*, Division of Corporation Finance of the SEC	• Rulemaking activities • Communications and transparency • Review process • Filing review statistics	SEC registrants
Michael J. Fay, *Associate Chief Accountant*, Division of Corporation Finance of the SEC	• Liquidity and capital resources section of MD&A	SEC registrants
Stephanie L. Hunsaker, *Associate Chief Accountant*, Division of Corporation Finance of the SEC	• Best practices for fair value MD&A disclosure	SEC registrants with significant financial assets/liabilities measured at fair value
Mark Mahar, *Associate Chief Accountant*, Office of the Chief Accountant of the SEC	• Materiality	SEC registrants and their auditors
Robert C. Pozen, *Chairman*, SEC Advisory Committee on Improvements to Financial Reporting	• Recommendations in the final CIFiR report to the SEC	Preparers, auditors, regulators, and users of financial statements
Arnold C. Hanish, *Vice President and Chief Accounting Officer*, Eli Lilly and Company Brian J. Lane, *Partner*, Gibson, Dunn & Crutcher LLP Pamela A. Long, *Assistant Director*, Division of Corporation Finance of the SEC	• MD&A	SEC registrants
Craig C. Olinger, *Deputy Chief Accountant*, Division of Corporation Finance of the SEC Allison M. Patti, *Professional Accounting Fellow*, Office of the Chief Accountant of the SEC	• Foreign private issuer statistics • Rulemaking • Other reporting issues • IOSCO initiatives	Foreign private issuers
Julie A. Erhardt, *Deputy Chief Accountant*, Office of the Chief Accountant of the SEC Liza McAndrew Moberg, *Professional Accounting Fellow*, Office of the Chief Accountant of the SEC	• Proposed IFRS roadmap	Preparers, auditors, regulators, and users of financial statements

INTERNAL CONTROL OVER FINANCIAL REPORTING		
Speaker	**Topics Covered**	**Affects**
Mark S. Beasley, *Deloitte Professor of Enterprise Risk Management and Professor of Accounting in the College of Management*, North Carolina State University Joseph V. Carcello, *Ernst & Young Professor in the Department of Accounting and Information Management*, University of Tennessee	• Study on fraudulent financial reporting from 1997 to 2007	General information for use by entities and auditors
Paul Beswick, *Deputy Chief Accountant, Professional Practice*, Office of the Chief Accountant of the SEC Marc Panucci, *Associate Chief Accountant*, Office of the Chief Accountant of the SEC	• Section 404 compliance issues and internal control disclosures • Section 404 implementation cost/benefit study • Current economic environment's effect on internal control	SEC registrants SEC registrants that are nonaccelerated filers SEC registrants and registered public accounting firms
AUDIT STANDARD SETTING		
Speaker	**Topics Covered**	**Affects**
Paul Beswick, *Deputy Chief Accountant, Professional Practice*, Office of the Chief Accountant of the SEC Jeff Ellis, *Professional Accounting Fellow*, Office of the Chief Accountant of the SEC Tom Ray, *Chief Auditor and Director of Professional Standards*, PCAOB Keith Wilson, *Associate Chief Auditor*, PCAOB	• PCAOB risk assessment standards • Other standard-setting activities of the PCAOB	Preparers and auditors of financial statements

The speeches of certain SEC staff members are available on the Commission's Web site at www.sec.gov. Please remember that though our goal is to be as accurate as possible, we have not confirmed the accuracy of this *Heads Up* with the SEC staff or with any other organization we refer to.

ACCOUNTING MATTERS

Speech by Adam Brown, *Professional Accounting Fellow*, Office of the Chief Accountant of the SEC

The full text of Mr. Brown's speech is available on the SEC's Web site.

Topics Covered	Affects
• Impairment of long-lived assets held for sale under Statement 144	Entities that have long-lived assets held for sale
• Measurement of liability-classified share-based payment awards	Entities anticipating an IPO that have share-based awards recorded as a liability
• Contracts indexed to a company's own stock	Entities that issue equity-linked financial instruments (embedded or freestanding)

Impairment of Long-Lived Assets Held for Sale Under Statement 144

Mr. Brown discussed an example in which a disposal group (consisting of long-lived assets and other assets such as accounts receivable and inventory) is held for sale and has a fair value less costs to sell that is less than its carrying value. In addition, this shortfall exceeds the net book value of the group's long-lived assets. Mr. Brown indicated that the SEC would not object to either of the following views regarding this situation:

- *First view* — An interpretation of paragraph 34 of Statement 144, which states, "A long-lived asset (disposal group) classified as held for sale shall be measured at the lower of its carrying amount or fair value less cost to sell." The entire disposal group would be considered the unit of account. Therefore, the disposal group would be recorded at the lower of its carrying amount or fair value less cost to sell (i.e., the carrying value of receivables and inventory would be reduced).
- *Second view* — This view is based on paragraph 37 of Statement 144, which limits the impairment to the carrying value of the long-lived assets within the disposal group. The paragraph states, "The loss or gain shall adjust only the carrying amount of a long-lived asset."

Mr. Brown cautioned, however, that the situation described above "may be an indicator that other assets such as [receivables] and inventory are impaired."

Measurement of Liability-Classified Share-Based Payment Awards

Mr. Brown discussed the measurement of a share-based payment award that is classified as a liability and that is therefore remeasured at a fair-value-based amount in each reporting period. He described a situation in which such an award contains a contingent feature whereby the award's value will increase upon the successful completion of an initial public offering.

> **Editor's Note:** Mr. Brown articulated two views on the measurement of a performance-based share-based liability that is affected by the successful completion of an initial public offering. We believe that Mr. Brown's remarks on the measurement of a performance-based share-based payment award in which the performance feature affects the value of the award warrant further clarification. Entities should consult with their professional advisers for updates on the clarification of Mr. Brown's remarks.

Contracts Indexed to a Company's Own Stock

Mr. Brown discussed the potential impact of Issue 07-5 for registrants that issue call options on their own stock (whether these call options are freestanding or embedded in other instruments, such as convertible debt). He noted that Example 8 of Issue 07-5 illustrates a characteristic of many equity-linked financial instruments — a feature in which the exercise price contains a reset feature if the company issues shares (or convertible instruments with a strike price) at a price lower than the instrument's exercise price. He stressed that this feature could lead to a change in how a registrant classifies (and subsequently measures) such instruments. Upon applying Issue 07-5, the registrant would conclude that the instrument

(e.g., call option or warrant) is not indexed to its own stock (i.e., cannot be classified within equity). Issue 07-5 is effective for fiscal years, including interim periods within those fiscal years, beginning after December 15, 2008 (January 1, 2009, for calendar-year-end entities). See the Panel Discussion on Implementation Issues of this *Heads Up* for additional insight into Issue 07-5.

Editor's Note: For a more detailed discussion of the application of Issue 07-5 to a company's equity-linked financial instruments, see Deloitte's December 5, 2008, *Heads Up*, Issue 07-5 Affects Issuers of Equity-Linked Financial Instruments (Including Debt With Embedded Conversion Options).

Speech by Muneera Carr, *Professional Accounting Fellow*, Office of the Chief Accountant of the SEC

The full text of Ms. Carr's speech is available on the SEC's Web site.

Topics Covered	Affects
• Fair value measurements	Entities with assets measured at fair value

In the context of the current market turmoil, Ms. Carr discussed her views on the challenges of measuring fair value, particularly in markets that are not active. She referred to the clarifying guidance in the joint press release issued by the staffs of the FASB and the SEC's Office of the Chief Accountant on September 30, 2008.

Editor's Note: See Deloitte's *Financial Reporting Alert* 08-11, SEC and FASB Release Fair Value Clarifications.

Her speech focused on three issues: "(1) whether unobservable inputs may be more appropriate than observable inputs in certain circumstances, (2) considerations on orderly transactions and market participants in markets that are not active, and (3) the use of pricing services and broker quotes."

- *Unobservable vs. observable inputs* — Ms. Carr emphasized that "sound judgment" is critical in the determination of whether to use unobservable inputs or observable inputs in the measurement of fair value. Observable inputs may not be the best estimate of fair value if such inputs are "not current, relevant, available without undue cost and effort, or require significant adjustments" to estimate fair value. In such circumstances, estimates of fair value based on valuation techniques that incorporate management's assumptions of the considerations that willing market participants would make (such as liquidity, uncertainty, and nonperformance risk) may be a better representation of fair value. While measurement techniques or inputs may have to be changed in inactive markets, the objective of determining fair value is always to arrive at the best estimate of the price a willing participant would pay in the current market.

Editor's Note: In a separate question-and-answer session, James L. Kroeker was asked whether the SEC staff would consider an approach in which the fair value of an asset is measured by using its average value over a recent period rather than only on the balance sheet date. He stated that this approach has been proposed and considered in the past, but is problematic because it does not represent an asset's fair value as of the balance sheet date.

- *Considerations in markets that are not active* — Ms. Carr reasserted that "unfavorable pricing or reduced liquidity" does not mean that a transaction is distressed or forced. She noted that significant judgment must be used in determining whether an observed transaction price is representative of an orderly transaction between "willing market participants," as the term is defined in Statement 157.
- *Use of pricing services and broker quotes* — Ms. Carr stated that management bears the ultimate responsibility for fair value measurements reported in the financial statements. To the extent that management relies on broker quotes or pricing services to estimate fair value, management must understand the source of the information and how such quotes or prices were determined. She warned that companies and auditors should "guard against placing undue reliance on such quotes solely because they consider the source of the information to be a third party."

Ms. Carr emphasized the importance of transparent disclosures as it relates to the significant judgments made in this area.

Editor's Note: See Deloitte's October 13, 2008, *Heads Up*, FASB Issues Guidance on Measuring Fair Value of Financial Assets in an Inactive Market, and Deloitte's *Financial Reporting Alert* 08-10, SEC Advises Registrants to Further Explain Fair Value in MD&A — An Addendum to the March 2008 SEC Letter.

Speech by Robert G. Fox III, *Professional Accounting Fellow*, Office of the Chief Accountant of the SEC

The full text of Mr. Fox's speech is available on the SEC's Web site.

Topics Covered	Affects
• Professional judgment	All entities
• Goodwill impairment	Entities with goodwill
• Push-down of debt under SAB Topic 5.J	SEC registrants with acquisition-related debt

Professional Judgment

Mr. Fox shared his thoughts on the SEC Advisory Committee on Improvements to Financial Reporting's (CIFiR's) recommendation that the SEC issue a "statement of policy articulating how the SEC staff evaluates the reasonableness of accounting judgments" as well as the factors it considers when making that assessment. Mr. Fox emphasized that registrants should "take a step back" before reaching conclusions about their accounting judgments and should consider the following questions:

- Have you accounted for your transaction or issue in a transparent manner?
- Have you carefully applied GAAP?
- Did you involve individuals with the appropriate level of knowledge and expertise?

He stated that if an SEC registrant is not comfortable with its answers to these questions, it should reconsider whether its accounting judgment was reasonable.

Mr. Fox also remarked that "the [SEC] staff does recognize that there may be a range of reasonable accounting judgments" for a particular transaction or issue. He indicated that "the staff's evaluation of the appropriateness of the registrant's judgment would be assisted by full and transparent disclosure surrounding the transaction." He emphasized that the SEC staff "does respect reasonable judgments made in good faith."

Mr. Fox pointed out that it would be "difficult for the [SEC] staff" to accept accounting judgments that are "potentially misleading," that "circumvent the objective" of an accounting standard, or that are unclear to investors. He cautioned that it is insufficient for a registrant to use a "respect my judgment" argument when defending a misleading accounting conclusion.

Editor's Note: CIFiR's final report indicated that the "policy statement" concerning professional judgment would not prevent regulators from challenging judgments and enforcing restatements when registrants do not apply GAAP properly. For more information on CIFiR's final report, see Deloitte's August 1, 2008, *Heads Up*, Complexity DeCIFiRed — SEC Advisory Committee Releases Final Report.

In a question-and-answer session, James L. Kroeker was asked about the SEC staff's progress in developing a statement of policy regarding a "judgment framework." In response, Mr. Kroeker explained that the staff has shifted its priorities to deal with the unprecedented events in the marketplace. He stated that he believes a judgment framework is right at the top of CIFiR's recommendations and that the staff will continue to work on implementing this recommendation.

Goodwill Impairment

Mr. Fox also discussed the evaluation of goodwill impairment under Statement 142. He acknowledged that given the recent market decline, the SEC staff is expecting to see "more goodwill impairments than in prior years." He raised the following points about goodwill impairment:

- The market capitalization of a registrant may not fully reflect the aggregate fair values of all the registrant's reporting units. Mr. Fox pointed to paragraph 23 of Statement 142, noting that "an entity might derive 'substantial value' from the ability to obtain control." Accordingly, this control premium may cause the fair value of all the registrant's reporting units to exceed the registrant's market capitalization. He also indicated that while it would be "prudent" for an entity to reconcile the aggregate fair value of its reporting units to its market capitalization, an entity should also consider other factors when assessing goodwill for impairment.

- The staff "does not have 'bright line' tests [for] determining the reasonableness of a control premium." Instead, an entity will need to "carefully analyze the facts and circumstances of [its] particular situation when determining an appropriate control premium."
- Recent market trends are an important factor in evaluating the appropriateness of a registrant's control premium. For example, it may sometimes be reasonable for the registrant to look at market capitalization over a reasonable period before the date on which goodwill is tested for impairment. However, Mr. Fox cautioned registrants not to ignore recent declines in their stock price when evaluating their control premiums.
- If a registrant concludes that its market capitalization does not reflect the aggregate fair value of its reporting units, the staff may ask it to support "the propriety of [its] control premium or other reasons for such a conclusion." He noted that such support could include comparable control premiums identified in other transactions or the cash flows associated with obtaining control of the reporting unit. However, he indicated that as the amount of a control premium increases, so does the amount of evidence required to support the registrant's judgments.

Editor's Note: Statement 142 does not require an entity to compare its market capitalization to the aggregate fair value of all of its reporting units. However, entities often perform such a comparison because it can sometimes yield useful information about the reasonableness of the fair value measurements. Also, the SEC staff frequently refers to the market capitalization of an entity when commenting about an entity's impairment testing of goodwill. Therefore, entities should be able to explain how a decline in market capitalization affected their judgments.

See the summary of remarks by Steven C. Jacobs for additional discussion about goodwill impairment.

Push-Down of Debt Under SAB Topic 5.J

Mr. Fox also discussed application of SAB Topic 5.J to situations in which more than one subsidiary is acquired. Specifically, he noted that some have questioned whether the **debt related to the acquisition** must, provided that the criteria of the SAB Topic are met, be pushed down to the respective financial statements of the multiple acquired subsidiaries. The question arises mainly because the guidance in SAB Topic 5.J only describes a situation in which there is a single subsidiary. Mr. Fox stated that the staff believes that SAB Topic 5.J should not be "interpreted to only apply to situations where one subsidiary is acquired." Therefore, when a subsidiary (1) "assume[s] the parent's debt," (2) uses the proceeds "to retire all or part of the parent's debt," or (3) "guarantees or pledges its assets as collateral for the parent's debt," acquisition-related debt must be pushed down to **all** subsidiaries acquired, provided that the criteria in SAB Topic 5.J are met.

Speech by Steven C. Jacobs, *Associate Chief Accountant*, Division of Corporation Finance of the SEC

The slides that Mr. Jacobs used in his presentation are posted on the AICPA's Web site (see slides 61–74).

Topics Covered	Affects
• Events and circumstances triggering goodwill impairment testing • Goodwill impairment disclosures	Entities with goodwill
• Valuation allowances for deferred tax assets	Entities with deferred tax assets
• Repatriation of foreign earnings	Entities that intend to repatriate, or have repatriated, foreign earnings

Events and Circumstances Triggering Goodwill Impairment Testing

Mr. Jacobs shared his perspective on goodwill impairment in the current economic environment, a topic on which the Division of Corporation Finance has focused much attention lately. Mr. Jacobs first discussed paragraph 28 of Statement 142, which notes examples of events and circumstances that may "more-likely-than-not reduce the fair value of a reporting unit below its carrying amount." If such impairment indicators are present, an entity may be required to test goodwill for impairment as of an interim date (i.e., before its annual testing date).

Mr. Jacobs suggested that entities consider the following indicators or "triggering events" in addition to those in paragraph 28:

- Cash or operating losses at the reporting unit.
- Consecutive operating results that are significantly lower than analysts' or internal forecasts.
- Significant revisions to internal or external forecasts.
- A new restructuring plan (also consider whether this constitutes a reorganization of the entity's reporting structure and whether a reallocation of goodwill is required).
- Market capitalization that is below book value.
- A negative long-term outlook for the industry in which the reporting unit operates.
- An increase in deferred tax valuation allowances at the reporting unit, which could arise from a reduction in the reporting unit's projected taxable income.

Mr. Jacobs noted that the SEC often asks entities how they have evaluated instances in which market capitalization is less than book value. He indicated that an entity should consider whether a decline in its market capitalization (1) aligns with comparative market indices resulting from general market movements or (2) is related to entity-specific events or indicators that lead to a triggering event. Lastly, he stressed that as the severity and duration of a deficiency increases, the SEC staff becomes more skeptical of an entity's assertion that a triggering event has not occurred.

Editor's Note: When the quoted market price of an entity's equity securities has declined, management should seek to identify the underlying cause of the decline to determine whether a triggering event has occurred. Significant declines in the quoted market price of an entity's equity securities can occur gradually as a result of a series of events that, individually, may not be reflected in the list of impairment indicators in paragraph 28 of Statement 142. The inability to identify an event or a change in circumstance when there has been a significant and sustained decline in the quoted market price of an entity's equity securities is expected to be infrequent.

See the summary of remarks by Robert G. Fox III for additional considerations on market capitalization and control premiums in the testing of goodwill for impairment.

Goodwill Impairment Disclosures

Paragraph 47 of Statement 142 requires an entity to disclose a "description of the facts and circumstances leading to the impairment" in the period in which the entity records a goodwill impairment. According to Mr. Jacobs, an entity should consider disclosing the triggering event leading to the goodwill impairment because this may help avert an SEC staff inquiry about whether the impairment should have been recorded in a previous period.

Under paragraph 22 of Statement 142, if the entity fails step 1 of the goodwill impairment test (i.e., the fair value of the reporting unit is less than its carrying amount), but has not completed step 2 before it issues the financial statements, the entity should record an estimate if the goodwill impairment is "probable and can be reasonably estimated." Mr. Jacobs observed that impairments are frequently probable if the reporting unit fails step 1, and typically an amount can be reasonably estimated on the basis of the step 1 results. Mr. Jacobs suggested that if an estimated loss is not recognized, entities should consider disclosing, at a minimum, the triggering event and the reasonably possible range of estimated loss. Mr. Jacobs also reminded entities that Statement 142 requires that the step 2 analysis be finalized by the end of the subsequent reporting period.

Mr. Jacobs urged entities to provide early warning disclosures in Management's Discussion and Analysis (MD&A) (see Item 303(a)(3)(ii) of Regulation S-K) and the notes to the financial statements (see SOP 94-6) when any of the following occur:

- The entity triggers an interim goodwill impairment test and narrowly passes step 1.
- The entity fails step 1 but the application of step 2 does not result in an impairment.
- The entity has not triggered an interim goodwill impairment test, but events that are reasonably likely to occur in the near future may trigger such a test.

He stated that in the spirit of transparent disclosure, entities should indicate the following items in their critical-accounting-estimate disclosures in MD&A:

- How reporting units are determined — i.e., at the operating segment or component level — and whether any components are aggregated.
- How the fair value of the reporting units is determined — i.e., under the cost, income, or market approach, or a combination of more than one approach, how the approaches were weighted, and what key assumptions were used.
- Other fair value approaches that were considered but not used and why.
- Sensitivity analyses showing how changes in assumptions would affect the step 1 and step 2 results.
- Changes in key assumptions from prior periods.

Mr. Jacobs ended his remarks on goodwill impairments by reminding entities that assumptions used in a goodwill impairment test (e.g., discount rate, estimated future cash flows) should be consistent with the assumptions used in other impairment tests for other long-lived assets, intangible assets, and deferred tax assets within that same reporting unit.

Valuation Allowances for Deferred Tax Assets

Mr. Jacobs recommended that entities disclose, in their critical accounting estimates section of MD&A, a discussion about the effect that the current economic environment is having on the realization assessments of their deferred tax asset balances. Specifically, Mr. Jacobs recommended that entities disclose:

- How cumulative losses in recent years, or cumulative losses expected in future periods, affect the realizability of deferred tax assets.
- Factors that were considered in each foreign, federal, or state jurisdiction (e.g., a certain jurisdiction may have a unique rule on the carryforward of net operating losses).
- New evidence obtained (either positive or negative) that affects the valuation of deferred tax assets (e.g., new tax-planning strategies).
- Uncertainties that could affect the realization of deferred tax assets.

Mr. Jacobs advised that when an entity adjusts a valuation allowance for a deferred tax asset, the entity should disclose the triggering event or new evidence leading to the adjustment, as well as the effect on current and future results. Also, he said that entities should consider early warning disclosures in MD&A (see Item 303(a)(3)(ii) of Regulation S-K) and the notes to the financial statements (see SOP 94-6) if an increase to the valuation allowance is reasonably likely in the near future.

Repatriation of Foreign Earnings

Mr. Jacobs observed that in the current economic environment, entities may need to repatriate cash from foreign subsidiaries. He warned that the repatriation of foreign earnings may trigger a tax accounting consequence.

Mr. Jacobs recommended disclosure of the current and anticipated effects of the repatriation of foreign earnings on the entity. Also, he recommended MD&A disclosure if there is uncertainty about the entity's need to repatriate foreign earnings, including the likelihood that such an event will occur and the likely effect on future earnings.

Editor's Note: Paragraph 12 of Opinion 23 states the following regarding entities that plan to repatriate cash from foreign subsidiaries:

> If circumstances change and it becomes apparent that some or all of the undistributed earnings of a subsidiary will be remitted in the foreseeable future but income taxes have not been recognized by the parent company, it should accrue **as an expense of the current period income taxes attributable to that remittance.** [Emphasis added]

Speech by Robert B. Malhotra, *Professional Accounting Fellow*, Office of the Chief Accountant of the SEC

The full text of Mr. Malhotra's speech is available on the SEC's Web site.

Topics Covered	Affects
• Substantive kick-out rights • Related-party considerations in applying Interpretation 46(R)	Holders or potential holders of variable interests
• Distributions from equity method investees	Equity method investors

Substantive Kick-Out Rights

Kick-out rights refer to the ability, by other partners or variable interest holders (investors), to dissolve a partnership or remove a general partner or decision maker. The existence of **substantive** kick-out rights affects application of the consolidation guidance in Issue 04-5 and Interpretation 46(R). Determining whether a kick-out right is substantive requires judgment. In making this judgment, one must assess whether a barrier exists that prevents investors from exercising their kick-out rights. Mr. Malhotra indicated that an assessment of barriers is critical under both Issue 04-5 and Interpretation 46(R), and he acknowledged that "it is sometimes the case that a decision maker is willing to grant kick-out rights [to investors] because the decision maker has concluded that the risk of removal is remote." In such circumstances it is important to understand why the risk of removal is considered remote to assess whether the right is substantive. For example, if exercising the kick-out right is considered remote because "the transition to another qualified replacement decision maker would likely disrupt the operations of the entity causing significant financial harm to the investors," the kick-out right may not be substantive and therefore should be ignored in the consolidation analysis.

Editor's Note: On September 15, 2008, the FASB issued an Exposure Draft proposing certain amendments to Interpretation 46(R) (see Deloitte's September 22, 2008, *Heads Up*, FASB Issues Exposure Documents That Eliminate QSPEs, Modify the Consolidation Model in Interpretation 46(R), and Expand Required Disclosures). One of the most significant proposed amendments was that all kick-out rights would be ignored (unless the rights are held by a single enterprise) in the determination of which enterprise is the primary beneficiary of the variable interest entity (VIE). In deliberations leading to the issuance of the Exposure Draft, some Board members indicated their belief that kick-out rights often are not substantive for entities within the scope of Interpretation 46(R) as evidenced by the fact that they are rarely, if ever, exercised.

Related-Party Considerations in Applying Interpretation 46(R)

The SEC staff has received inquiries about the application of paragraph 5(c) of Interpretation 46(R). Specifically, the staff has been asked whether certain close business associates (e.g., a relationship between a professional service provider and one of its significant clients) could be considered related parties under Statement 57 and Interpretation 46(R). A related-party relationship may affect whether an entity is considered a VIE pursuant to paragraph 5(c) of Interpretation 46(R). Mr. Malhotra stated that a close business associate may be considered a related party "if one party can control or can significantly influence the other party to an extent that one of the parties might be prevented from fully pursuing their own separate interests should that party choose to do so." Therefore, according to Mr. Malhotra, "the mere past practice or future intent of close business associates to collaborate would be insufficient to conclude the parties are related."

Distributions From Equity Method Investees

Mr. Malhotra indicated that the SEC staff will not object to an investor's gain recognition for cash distributions made by an equity method investee when the distributions exceed the carrying value of the investor's equity method investment provided that "the investor is not liable for the obligations of the investee nor otherwise committed to provide financial support."

Speech by Russell Golden, *Technical Director*, FASB

James L. Kroeker, *Deputy Chief Accountant*, Office of the Chief Accountant of the SEC

Panel Discussion on Technical Issues

Panel Discussion on Business Combinations

Valuation Perspectives on Recent Accounting Issues

Topics Covered	Affects
• Recently issued U.S. GAAP accounting standards • FASB standard-setting activities expected in the near future	All entities

Speech by Russell Golden, *Technical Director*, FASB

Introduction

Mr. Golden's remarks focused on the FASB's work plan, which contains the expected timing and details of all current FASB projects.

Anticipated New Projects

Mr. Golden indicated that the FASB staff will ask the FASB chairman to add projects to the Board's agenda that address other-than-temporary impairment (OTTI) and embedded credit derivatives. This request is the result of input received by the FASB staff on a joint IASB/FASB discussion paper, Reducing Complexity in the Reporting of Financial Instruments, and the recent global financial crisis roundtables sponsored by the IASB and FASB. Mr. Golden noted that the new projects would cover (1) OTTI disclosures aimed at clarifying the different impairment models for financial statement users; (2) application of the various existing OTTI models; and (3) clarification of paragraph 14B of Statement 133, which discusses whether an embedded credit derivative must be separated from its host contract. The FASB discussed these new projects at its December 15, 2008, meeting.

Editor's Note: For more information about the discussion paper, see Deloitte's April 2, 2008, *Heads Up*, Making the Complex Less Complex — FASB Invites Comments on IASB's Financial Instruments Discussion Paper. More information on the financial crisis roundtables is available on the FASB's Web site and on the IAS Plus Web site.

Revisions to Statement 140 and Interpretation 46(R)

Mr. Golden briefly discussed the FASB's ongoing projects to amend Statement 140 and Interpretation 46(R). These projects reflect the Board's response to the increased scrutiny by the SEC, Congress, and financial statement users on the accounting and disclosure requirements of these standards because of the recent deterioration in the global credit markets. The FASB staff is analyzing extensive feedback received from comment letters and the two roundtables held on these projects. The FASB is expected to issue final standards amending the accounting models in Statement 140 and Interpretation 46(R) in late March or early April 2009. The standards are expected to be effective in 2010.

Because of the pressing need to improve transparency about transfers of financial assets and an enterprise's involvement with variable interest entities, including qualifying special-purpose entities, on December 11, 2008, the FASB issued FSP FAS 140-4 and FIN 46(R)-8. The FSP, which became effective on December 15, 2008, accelerates the requirement for public companies to provide disclosures similar to those proposed in the pending amendments to Statement 140 and Interpretation 46(R).

Editor's Note: For more information about the projects to reconsider certain aspects of Statement 140 and Interpretation 46(R), see Deloitte's September 22, 2008, *Heads Up*, FASB Issues Exposure Documents That Eliminate QSPEs, Modify the Consolidation Model in Interpretation 46(R), and Expand Required Disclosures. For more information about the disclosures FSP, see Deloitte's December 16, 2008, *Heads Up*, FASB's New Disclosure FSP Is Effective Immediately.

Fair Value in Inactive Markets

Mr. Golden indicated that the FASB issued FSP FAS 157-3 in October 2008 to address constituents' concerns about the application of Statement 157 to fair value measurements of financial assets traded in inactive markets. He noted that the FSP clarifies that:

- An entity cannot conclude that all sales in a particular market are distressed. Rather, the entity must make this determination for each individual transaction. In addition, an entity cannot assume that an observable transaction is at fair value; this determination requires due diligence. Mr. Golden noted that the recently issued IASB Expert Advisory Panel report can help entities determine fair value in an inactive market. (This report is available on the IASB's Web site.)
- An entity can use its own cash flow model (an income approach) when **relevant** observable transactions (or inputs) are not available.
- It may be appropriate for an entity to consider broker quotes and pricing services information; however, such information is not necessarily determinative of fair value. Mr. Golden indicated that entities should rely less on model-based quotes than on transaction-based quotes.

Mr. Golden emphasized Statement 157's requirement to use market participant considerations. He stressed that market participants believe that today's markets contain more risk and are factoring that increased risk into their fair value measurements (e.g., by incorporating adjustments for nonperformance and liquidity).

Editor's Note: FSP FAS 157-3 amended Statement 157 by incorporating "an example to illustrate key considerations in determining the fair value of a financial asset" in an inactive market. The FSP is effective upon issuance. For more information about this FSP, see Deloitte's October 13, 2008, *Heads Up*, FASB Issues Guidance on Measuring Fair Value of Financial Assets in an Inactive Market.

Accounting for Contingencies Acquired in a Business Combination

Mr. Golden stated that the FASB plans to issue proposed FSP FAS 141(R)-a that would amend Statement 141(R)'s accounting for acquired contingencies. The proposed effective date is the same as Statement 141(R)'s. Proposed FSP FAS 141(R)-a would require that contingencies acquired in a business combination be measured at fair value if they can be reasonably determined. If not, the acquirer would apply Statement 5 and record the contingency if it is probable and can be reasonably estimated. This proposal is expected to change the Statement 141(R) model of accounting for some acquired contingencies to make it more consistent with the current model in Statement 141.

Editor's Note: Statement 141(R) currently requires that acquired contractual contingencies be measured at fair value and that noncontractual contingencies be measured at fair value only if it is more likely than not that the contingency gives rise to an asset or liability as defined in Concept Statement 6. The FASB's amendment of this guidance would not create an additional difference between Statement 141(R) and IFRS 3, since the FASB's and IASB's guidance on the accounting for acquired contingencies was not originally converged. The FASB issued the proposed FSP on December 15, 2008. See Deloitte's December 17, 2008, *Heads Up*, FASB's Contingency Plan — FASB Proposes FSP to Amend Statement 141(R)'s Guidance on Contingencies.

Statement 160 Implementation Issues

Mr. Golden discussed the status of various projects arising from conflicts between Statement 160 and other accounting literature. In particular, he observed that Issue 08-10 amends ARB 51 to limit application of its partial sale and deconsolidation provisions to entities that are considered *substantive*. This amendment precludes application of partial sale and deconsolidation provisions to situations in which a shell company is created solely to obtain an accounting treatment that differs from what would otherwise be required under other applicable GAAP.

Editor's Note: For more information about Issue 08-10 and other Statement 160 implementation issues, see Deloitte's November 2008 *EITF Snapshot*.

Accounting Standards Codification Project

Mr. Golden stated that he expects the FASB to approve the Accounting Standards Codification as the sole source of U.S. GAAP in early 2009. (The Codification is expected to become effective on July 1, 2009.) Mr. Golden cautioned that although the Codification would not substantively change existing GAAP, constituents may interpret the new wording differently than they did before. Mr. Golden indicated that the FASB will consider whether to provide transition guidance upon adopting the Codification.

> **Editor's Note:** For additional information about the FASB's Codification project, see Deloitte's January 18, 2008, *Heads Up*, FASB Releases U.S. GAAP Codification for Verification. Also see the FASB's Codification Web site. Note that during the verification period, users must register for free access to the Codification.

James L. Kroeker, *Deputy Chief Accountant*, Office of the Chief Accountant of the SEC

Other-Than-Temporary Impairment (OTTI)

Mr. Kroeker addressed questions on determining when an investment is other-than-temporarily impaired, stating that because the SEC has no "bright lines" or "safe harbors," the determination must be based on individual facts and circumstances. He referred participants to the September 30, 2008, press release from the SEC's Office of the Chief Accountant and the FASB staff, "Clarifications on Fair Value Accounting," for further guidance on the SEC's views.

> **Editor's Note:** For more information, see Deloitte's *Financial Reporting Alert* 08-16 (Revised), SEC Issues Letter Clarifying Other-Than-Temporary Impairment Guidance for Perpetual Preferred Securities, and Deloitte's *Accounting Roundup*: Third Quarter in Review — 2008.

Classification of Securities Issued Under the Troubled Asset Relief Program

Mr. Kroeker addressed a question on the accounting by entities issuing securities under the Troubled Asset Relief Program (TARP). He stated that equity classification of the perpetual preferred securities is pretty clear under existing guidance in U.S. GAAP (in the absence of some provisions that would result in liability classification, such as mandatory redemption). He also stated that equity classification of the warrants seems consistent with existing guidance in U.S. GAAP, with one caveat. The entity must have sufficient authorized shares to settle the warrants by the end of the quarter in which they are issued; otherwise the entity cannot classify those warrants as equity until it receives authorization to issue sufficient shares.

> **Editor's Note:** For more information, see the October 24, 2008, letter sent to the Treasury by the staff of the SEC's Office of the Chief Accountant and the FASB.
>
> See also the Division of Corporation Finance's November 24, 2008, release, "Staff Guidance for Financial Institutions Filing Proxy Statements in Connection With the TARP Capital Purchase Program."

Pensions

Mr. Kroeker also addressed questions about pension plan accounting.

Mr. Kroeker indicated that the SEC staff is aware that it will be difficult for companies to measure pension plan obligations in light of the requirement, which begins this year-end, to align the pension measurement date with a company's year-end. He stated that the SEC staff realizes that much of the work related to measuring the benefit obligation may be done in advance and rolled forward to year-end. He also remarked that a rollforward approach would not be appropriate for plan assets with readily determinable fair values. He observed that an entity should be able to measure plan assets with readily determinable fair values at year-end without much difficulty.

Continuing the discussion on pensions, Mr. Kroeker cautioned that an entity should use a discount rate that reflects reasonable assumptions as of the measurement date. Specifically, he discussed the following:

- Given the current economic environment and volatility in the market, an entity using a rollforward approach for pension obligations should be aware that a discount rate that was reasonable one or two months ago might not be reasonable as of the measurement date.

- Companies that use hypothetical bond portfolios to support the discount rate when measuring their postretirement benefit obligations should evaluate the impact of current market conditions on both bond pricing and bond selection. Companies should consider excluding "outliers" from their hypothetical bond portfolios when developing their postretirement plan discount rates. Outliers include bonds that have high yields because (1) the issuer is on review for possible downgrade by one of the major rating agencies or (2) recent events have caused significant price volatility and the rating agencies have not yet reacted.
- When a company develops a hypothetical bond portfolio, it should consider whether there are enough bonds at a particular rating available (i.e., "capacity") in the market to cover the pension obligation. If an entity is using certain indices to select a discount rate, the capacity of some of the bonds in the index may not be sufficient to cover the pension obligation of many plans in the current environment. Capacity constraints alone would not (1) preclude an entity from considering those bonds as inputs in developing the discount rate or (2) require an entity to default to using a treasury rate or AAA-rated securities, but it is important to consider whether the entity has met the overall objective of developing a reasonable high-credit quality rate.

Editor's Note: Statement 158 requires entities to measure the fair value of plan assets and benefit obligations as of the date of their year-end balance sheet. Beginning in fiscal years ending after December 15, 2008, an entity will no longer be able to choose a measurement date up to three months before year-end. Paragraph 10 of Statement 87 does allow an entity to employ computational shortcuts (e.g., rollforward methods) if the results are "reasonably expected not to be materially different from the results of a detailed application." However, because of the current volatility in the credit markets, it may be difficult for an entity that is employing computational shortcuts to measure plan assets or calculate its benefit obligation to demonstrate whether it has met the requirements of paragraph 10. For more information, see Deloitte's *Financial Reporting Alert* 08-19, Pension and Other Postretirement Benefits Affected by Turmoil in the Credit Markets.

Panel Discussion on Technical Issues by:

Shea Malcolm, *Practice Fellow*, FASB

Brian Stevens, *Partner*, KPMG LLP

Introduction

Ms. Malcolm and Mr. Stevens discussed various implementation issues associated with FSP APB 14-1, Issues 07-5 and 08-8, and Statement 161, which are becoming effective over the next few months.

Transition for Instruments Affected by Both FSP APB 14-1 and Issue 07-5

Ms. Malcolm observed that some financial instruments (e.g., convertible debt instruments that may be settled partially or wholly in cash upon conversion) may be within the scope of both FSP APB 14-1 and Issue 07-5. While both standards have the same effective dates (fiscal years beginning after December 15, 2008), their transition guidance is different. FSP APB 14-1 requires retrospective application, while Issue 07-5 requires a cumulative-effect adjustment to opening retained earnings. Therefore, financial statement preparers need to consider which transition guidance to apply first. Ms. Malcolm stated that since the transition for Issue 07-5 only applies to instruments that are outstanding on or after its effective date, an entity should first apply FSP APB 14-1 retrospectively. The entity should then apply Issue 07-5 to calculate the cumulative-effect adjustment and apply it prospectively from its effective date.

Editor's Note: FSP APB 14-1 applies to the convertible debt instruments described above, unless the embedded conversion option must be accounted for separately as a derivative under Statement 133. Issue 07-5 indicates when a financial instrument is indexed to the issuer's own stock (one of the considerations in determining whether an instrument (or embedded feature) is within the scope of Statement 133).

Example

A calendar-year public entity issued a convertible debt instrument in fiscal year 2006. The instrument is outstanding as of January 1, 2009 (i.e., the effective date of both FSP APB 14-1 and Issue 07-5 for the entity), and is subject to the transition requirements in both FSP APB 14-1 and Issue 07-5. In its fiscal year 2009 financial statements, the entity must present three years of comparative information (i.e., fiscal years 2007, 2008, and 2009). Before Issue 07-5, the embedded conversion option in the convertible debt qualified for the paragraph 11(a) scope exception in Statement 133 and was not separated from its host contract. After the effective date of Issue 07-5, the embedded conversion option no longer qualifies for this exception and must be accounted for separately (i.e., the convertible debt instrument will no longer be within the scope of FSP APB 14-1).

In this example, the entity would apply the FSP only to the two earliest comparative years presented in its 2009 financial statements (i.e., fiscal years 2007 and 2008). However, the entity would only apply Issue 07-5 to the convertible debt instrument in fiscal year 2009 because its application would result in the embedded conversion option being separated from its host contract (i.e., the convertible debt instrument is no longer within the scope of FSP APB 14-1 as of January 1, 2009).

Interaction of FSP APB 14-1 and Issues 98-5 and 00-27

During the question-and-answer session of the panel discussion, Mr. Stevens noted that instruments within the scope of FSP APB 14-1 will no longer be subject to the beneficial conversion feature accounting guidance in Issues 98-5 and 00-27.

Editor's Note: For more information about FSP APB 14-1, see Deloitte's May 15, 2008, *Heads Up*, Top Down on Convertibles? — FASB Tightens Convertible Debt Accounting for Issuers.

Issue 07-5's Effect on Strike Price Adjustment and Antidilution Features

Ms. Malcolm discussed how the Issue 07-5 model may affect an entity's conclusion about whether an instrument (or embedded feature) is indexed to the entity's own stock. Example 8 of Issue 07-5 highlights the issue she discussed. This example deals with features in which the strike price of the equity-linked instrument is adjusted to the then-current market price of future issuances of (1) equity shares (i.e., to the issuance price of the issued shares) or (2) other equity-linked instruments (i.e., to the strike price of the new instrument). Ms. Malcolm explained that such adjustment features preclude the instrument (or embedded feature) from being considered indexed to the entity's own stock for purposes of qualifying for the paragraph 11(a) scope exception in Statement 133 or for equity treatment under Issue 00-19 (i.e., a freestanding instrument not considered indexed to an entity's own stock is not within the scope of Issue 00-19).

Editor's Note: This is because those features are **not** inputs to the pricing of a fixed-for-fixed forward or option on equity shares. The second step of Issue 07-5's two-step model (evaluate the settlement provisions) allows adjustment to the settlement amount if the only variables that could affect the settlement amount are inputs to the fair value of a fixed-for-fixed forward or option on equity shares.

Mr. Stevens noted that these features are already quite common in pre-IPO deals and private placements. However, he cautioned that such features are becoming increasingly common for SEC registrants because investors increasingly want price protection from decreasing share prices in the current turbulent markets.

Editor's Note: These features are common in the conversion option in convertible instruments issued by pre-IPO entities. In determining whether such embedded conversion options are derivatives, such entities may have concluded that the conversion option did not meet the net settlement criterion in Statement 133 (e.g., the instrument did not have explicit net settlement provisions and the underlying shares were not readily convertible to cash) and did not need to be accounted for as a derivative. After an IPO, the instrument would most likely meet the net settlement criterion (i.e., the underlying shares are now readily convertible to cash) and the entity would need to reassess its previous accounting conclusions for the instrument, including whether the instrument would meet the scope exceptions in Statement 133 as affected by related guidance such as Issue 07-5.

In response to a question, Ms. Malcolm noted that a stock split adjustment feature or a similar antidilution feature does not preclude an instrument (or embedded feature) from being considered indexed to the entity's own stock under Issue 07-5. However, she cautioned that the contract wording for strike price adjustment features may be similar to the contract wording for certain antidilution provisions (e.g., a stock split). She emphasized that entities need to analyze all adjustment features, even those characterized as antidilution provisions, to determine whether the feature would prevent the instrument or embedded feature from being considered indexed to the issuer's stock under Issue 07-5.

Editor's Note: For more information about the effect of Issue 07-5 on freestanding instruments (or instruments containing embedded features) containing these types of adjustment features, as well as other implementation issues, see Deloitte's December 5, 2008, *Heads Up*, Issue 07-5 Affects Issuers of Equity-Linked Financial Instruments (Including Debt With Embedded Conversion Options).

Issue 07-5's Effect on the Clearly and Closely Related Determination

Ms. Malcolm discussed whether Issue 07-5 affects the determination of whether an embedded feature is considered clearly and closely related to its host contract. She responded that the Task Force did not discuss the notion of clearly and closely related during its deliberations of Issue 07-5 and that it did not intend to change the determination of whether an embedded feature is clearly and closely related to its host contract.

Statement 161 Implementation Issues

Ms. Malcolm reiterated that Statement 161 amended Statement 133 but did not change its recognition or measurement provisions. Statement 161 only resulted in additional disclosures for derivative instruments and hedging activities.

Editor's Note: For more information about Statement 161, see Deloitte's March 27, 2008, *Heads Up*, FASB Expands Disclosures About Derivative Instruments and Hedging Activities.

Ms. Malcolm also discussed Statement 161's effective date (i.e., fiscal years and interim periods beginning after November 15, 2008), noting that entities only need to provide the required disclosures for periods beginning after November 15, 2008. She pointed out that public entities with a fiscal year ending on March 31, 2009, should include fourth-quarter information in the disclosures because their fourth quarter begins after November 15, 2008 (i.e., January 1, 2009).

Editor's Note: The FASB clarified Statement 161's effective date and transition provisions in FSP FAS 133-1 and FIN 45-4, which amends Statement 133 and Interpretation 45. For more information, see Deloitte's September 18, 2008, *Heads Up*, FASB Issues FSP Requiring Enhanced Disclosure for Credit Derivative and Financial Guarantee Contracts.

Panel Discussion on Business Combinations by:

Kristofer E. Anderson, *Valuation Fellow*, FASB

Kevin McBride, *Accounting Policy Controller*, Intel Corporation

Joe Ucuzoglu, *Partner*, Deloitte & Touche LLP

The panelists summarized the significant changes to the accounting for business combinations and noncontrolling interests (formally referred to as minority interests) as a result of the issuance of Statements 141(R) and 160.

Editor's Note: Statements 141(R) and 160 are effective for fiscal years beginning on or after December 15, 2008. Deloitte's December 12, 2007, *Heads Up*, Major Changes to Business Combination Accounting as FASB and IASB Substantially Converge Standards, highlights many of the topics discussed by the panelists.

Deloitte's *Financial Reporting Alert 08-18*, Effect of Statement 141(R) on Income Tax Accounting, addresses the income tax considerations discussed by the panelists as well as additional changes to income tax accounting resulting from Statement 141(R).

Also, stay tuned for Deloitte's updated Business Combinations Roadmap, which will be issued later this month.

Editor's Note: In a question-and-answer session, Craig C. Olinger acknowledged that certain guidance in Regulation S-X conflicts with the guidance in Statements 141(R) and 160. In such cases (and until the SEC finalizes amendments to Regulation S-X), an entity should apply the guidance in Statements 141(R) and 160.

Topic D-98

Mr. Ucuzoglu discussed the SEC's recent revisions to Topic D-98, which provide SEC registrants with guidance on classifying and measuring certain securities with redemption features. The SEC made the revisions primarily to address the interaction between Topic D-98 and Statement 160. Mr. Ucuzoglu clarified that redeemable noncontrolling interests are classified in temporary equity in accordance with Topic D-98, and would not be classified as permanent equity pursuant to

the presentation requirements of Statement 160. He reminded registrants that Topic D-98 contains guidance on calculating earnings per share when redeemable noncontrolling interests are outstanding. Specifically, he mentioned that when a parent is required to redeem a noncontrolling interest in the common equity of a subsidiary (e.g., put option) for an amount other than its fair value, it should apply the two-class method described in Statement 128.

> **Editor's Note:** For more information on the recent revisions to Topic D-98, see Deloitte's March 2008 *EITF Snapshot* and the minutes of the March EITF meeting, which are marked for changes made to Topic D-98 as a result of Statements 141(R) and 160.

Valuation Perspectives on Recent Accounting Issues by:

Stamos Nicholas, *Principal*, Deloitte Financial Advisory Services LLP

P.J. Patel CFA ASA, *Partner*, Valuation Research Corporation

Gary Roland, *Managing Director*, Duff and Phelps

Evan Sussholz, *Professional Accounting Fellow*, Office of the Chief Accountant of the SEC

Overall Discussion

The panelists agreed that the same valuation models (e.g., market, income, and cost approaches) for measuring assets acquired in a business combination would continue to be used after the adoption of Statements 141(R) and 157. However, the inputs to those valuation models will sometimes differ because Statement 157 requires the use of market participant assumptions rather than entity-specific assumptions.

Contingent Consideration in Business Combinations

The panelists agreed that the income approach (i.e., a discounted cash flow model) would generally be used to measure the fair value of the contingent consideration. The panelists noted that an entity generally would use probability-weighted cash flows to incorporate any uncertainty related to the amounts and timing of the contingent payments into the expected future cash flows, instead of trying to incorporate these considerations into the discount rate. The panelists also agreed that the use of observable inputs in the valuation should be maximized — for example, an entity could factor industry data into the development of discount rates.

Intangible Assets

The panelists agreed that an entity must value an intangible asset acquired in a business combination, including a defensive value asset, by assuming the highest and best use of the asset by market participants instead of the acquirer's intentions or the terms of the deal. Accordingly, entities need to understand the market and how a market participant would use an intangible asset (defensively or offensively) when determining the fair value measurement for an intangible asset. The panelists agreed that if the highest and best use of an intangible asset is as part of an asset group (e.g., an operating business), the intangible asset must be valued at the asset-group level.

> **Editor's Note:** Example 1 in Appendix A of Statement 157 illustrates determining the highest and best use to a market participant by valuing the asset in combination with other assets rather than individually.

Speech by James Leisenring, *Member*, IASB

Topics Covered	Affects
• IFRSs and convergence projects with the FASB	Prepares, auditors, and users of IFRS financial statements

Convergence

Mr. Leisenring noted that the FASB and IASB share the same goal for the development of high-quality accounting standards. He stated that to achieve this goal, the FASB and IASB have recently reaffirmed their commitment to work together on several convergence projects described in their updated Memorandum of Understanding (MOU). The boards expect to complete all convergence projects by 2011. Furthermore, he stated that the FASB and IASB staffs have established mechanisms for better communication and coordination between their respective interpretive bodies, the EITF and IFRIC.

He indicated that convergence efforts and improvements to IFRSs were key considerations leading to the SEC's final rule (issued in December 2007) to eliminate the U.S. GAAP reconciliation for foreign private issuers. Such convergence efforts and improvement are also one of the milestones in the SEC's recently issued proposed IFRS "roadmap." Mr. Leisenring encouraged participation in the SEC's comment letter process for the IFRS roadmap and stressed the importance of the SEC's requirement to use IFRSs as issued by the IASB, as opposed to jurisdictional versions of IFRSs.

Editor's Note: The debate about the comparability of jurisdictional versions of IFRSs was highlighted in a February 2008 public statement issued by the International Organization of Securities Commissions (IOSCO), which encouraged more transparent information on the accounting standards used to prepare financial statements. Investors may be making decisions without a full understanding of the accounting standards used, particularly when an entity uses national standards that are a variation of IFRSs, rather than IFRSs as issued by the IASB. That risk may be mitigated by clear information provided to investors on the accounting standards used to prepare financial statements. See the summary of remarks by Julie A. Erhardt and Liza McAndrew Moberg for further discussion on the IFRS roadmap.

IASB Agenda

Mr. Leisenring summarized the projects on the IASB's agenda, focusing primarily on convergence projects under the MOU. He also mentioned that exposure documents for the income taxes, revenue, and leasing projects are expected to be issued in January 2009. He noted that although the income tax project was a convergence project, the exposure draft will include an approach for uncertain tax positions that differs from that in Interpretation 48. Mr. Leisenring then discussed the long-term convergence projects in the MOU, which are in various stages of completion. He noted that to meet the MOU's targeted 2011 completion deadline, the FASB and IASB reprioritized and revised the scope of several of the projects in the updated MOU. He emphasized that in addition to its efforts on the MOU projects, the Boards' work on the conceptual framework is critical to the future of high-quality accounting standards.

Editor's Note: Additional information on the status of all current projects on the IASB's agenda is available on the IASB's Web site, including projected timetables, meeting summaries, and tentative decisions.

For additional information on the updated MOU, see Deloitte's September 16, 2008, *Heads Up*, FASB and IASB Publish Plan for Completion of Major Joint Projects by 2011 and on the IAS Plus Web site.

Credit Crisis

Mr Leisenring acknowledged that current global market conditions have affected the IASB's agenda and priorities in 2008. Mr. Leisenring noted that in response to the credit crisis, the IASB expedited certain projects (consolidations, derecognition, and fair value measurement projects). An expert advisory panel was also formed to address valuation and disclosure issues encountered in the current market environment. He stated that all these actions are intended to improve confidence in financial reporting, despite political pressures that may try to undermine it. He emphasized that the globalization of financial markets has made critical the need for converged accounting standards. He noted that this past year, the IASB was compelled to suspend its normal due process because of pressure from politicians and "heads of state" to change certain aspects of IFRSs under the pretext that convergence with U.S. GAAP was required in the current economic environment. As a result, the IASB issued amendments to IAS 39 and IFRS 7 to permit reclassification of certain financial assets classified as trading in rare circumstances, as permitted under U.S. GAAP.

Editor's Note: For additional information on the IASB's actions in response to the credit crisis, refer to the credit crisis page on the IASB's Web site.

SEC MATTERS

Speech by John W. White, *Director*, Division of Corporation Finance of the SEC

Topics Covered	Affects
• The market crisis and the role of the Division of Corporation Finance • Enhancing transparency: how the Division of Corporation Finance interacts with the public	SEC registrants

The Market Crisis and the Role of the Division of Corporation Finance

Mr. White discussed how the market crisis has affected the Division of Corporation Finance (the "Division") and noted the following:

- The Division staff is trying to be even more responsive to preparers in an effort to facilitate capital raising and strategic transactions. The Division staff does not want the filing review process to unnecessarily interfere with capital raising efforts and has been expediting issues. The Division staff may be contacted regarding any questions or issues.
- The Division's rule-making schedule has been altered as a result of the market crisis. In a speech on November 21, 2008, "Don't Throw Out the Baby With the Bathwater," he summarized the Division's rulemaking initiatives.

Editor's Note: Mr. White indicated that he hoped the Division would be able to issue a final rule on XBRL by the end of the year. During an open Commission meeting on December 17, 2008, the SEC approved the issuance of two releases that would amend the SEC regulations to include rules requiring the use of XBRL. Refer to the SEC's Web site for more information.

- The Division staff is considering the current market conditions in determining which registrants to select for review in 2009. In addition to requiring that each issuer is reviewed not less than once every three years, the Sarbanes-Oxley Act requires that the Division staff consider factors such as market volatility and registrants with large market capitalization in selecting which registrants to review.

Mr. White indicated that in 2009, the Division will review the annual and other periodic reports (i.e., Forms 10-K, 10-Q, and 8-K) of all of the very largest financial institutions in the United States that are public companies. This group will include the nine large financial institutions that have already agreed to participate in the Troubled Asset Relief Program (TARP). The SEC staff (both accounting and legal) will perform a full review of the documents, including the financial statements and the executive compensation disclosures of these companies.

Mr. White stated that as a result of the market crisis, registrants will need to provide more disclosures. He noted the following:

- *Registrants participating in the TARP* — Many of these registrants may need to file a proxy statement to issue shares to the government. The Division has issued sample comments and other guidance related to these proxy statements (see Staff Guidance for Financial Institutions Filing Proxy Statements in Connection With the TARP Capital Purchase Program). These registrants will need to file various Forms 8-K for many items related to the TARP (e.g., under Item 1.01, Entry Into a Material Definitive Agreement). The effects of government ownership should be incorporated into both Management's Discussion and Analysis (MD&A) and executive compensation disclosures.
- *All other registrants* — Registrants need to adequately incorporate the effects of current market conditions in MD&A. Because of the pervasiveness of the market crisis this year, in particular, registrants should consider taking a "clean-slate" approach rather than simply making edits to the prior-year MD&A. Further, registrants should incorporate the effects of the crisis on their suppliers, customers, etc. The 2003 Interpretative Release on MD&A, as well as the recently issued PCAOB Staff Audit Practice Alert No. 3 provide guidance in this area. **All** registrants should consider disclosures related to the limitations set by the TARP on compensation arrangements that could lead a financial institution's senior executive officers to take unnecessary and excessive risks.

Editor's Note: Mr. White discussed the Division's filing-review program changes, as well as disclosures related to the limitations set by the TARP on compensation arrangements, in more detail in his October 21, 2008, speech, Executive Compensation Disclosure: Observations on Year Two and a Look Forward to the Changing Landscape for 2009. Several other speakers at the Conference also provided insight on MD&A disclosure. Refer to the summaries of remarks by Stephanie L. Hunsaker, Michael J. Fay, and Steven C. Jacobs for additional information.

Enhancing Transparency: How the Division of Corporation Finance Interacts With the Public

Mr. White highlighted several initiatives taken by the Division over the last few years to increase transparency, including:

- A relaunch and reorganization of the Division's Web site, to make items easier to find.
- Updates to hundreds of legal interpretations (i.e., Compliance and Disclosure Interpretations) and the establishment of a mechanism for updating them in the future.
- A substantial increase in the number of comment and no-action letters available on EDGAR.
- A focus on providing forward-looking disclosure advice such as "Dear CFO Letters," Division guidance on disclosures in proxy statements related to the TARP (refer to discussion above), and comment letter summaries (e.g., executive compensation, IFRSs). The Division seeks to influence registrants' disclosures and provide advice before registrants file reports with the Commission rather than raise issues post-submission through the staff's review process.

Editor's Note: In a separate question-and-answer session, Wayne E. Carnall indicated that the Division plans to issue forward-looking disclosure guidance related to community banks before the upcoming financial reporting season.

- The posting on its Web site of an overview of the Division's Filing Review Process as well as an Overview of the Legal and Regulatory Policy Offices. These documents specify (1) how the Division selects filings for review, (2) the organization of the Division and contact information, and (3) the reconsideration process.

Speeches by:

Wayne E. Carnall, *Chief Accountant*, Division of Corporation Finance of the SEC

Craig C. Olinger, *Deputy Chief Accountant*, Division of Corporation Finance of the SEC

The slides that Mr. Carnall and Mr. Olinger used in their presentations are posted on the AICPA's Web site (refer to slides 1–32).

Topics Covered	Affects
• Rulemaking activities • Communications and transparency • Review process • Filing review statistics	SEC registrants

Rulemaking Activities

Mr. Carnall discussed the SEC's rulemaking activity during the year and highlighted the following rules, proposals, and concept release:

- Roadmap for the Potential Use of Financial Statements Prepared in Accordance With International Financial Reporting Standards by U.S. Issuers (proposed IFRS "roadmap").
- Foreign Issuer Reporting Enhancements (FIRE).

- Proposed rule and concept release for oil and gas companies.
- XBRL.

Mr. Carnall encouraged attendees to provide comments on the SEC's proposed IFRS roadmap, which consists of two parts: (1) the mandatory adoption of IFRSs (as issued by the IASB) by U.S. companies by 2014 and (2) the optional adoption of IFRSs by certain eligible companies, beginning with filings made in 2010 for fiscal years ending on or after December 15, 2009. Registrants wishing to avail themselves of that option would need to submit a letter to the Division of Corporation Finance (the "Division") outlining why they believe they are eligible. If a registrant is successful and receives an SEC staff letter of no objection to the registrant's use of IFRSs, the letter will be made publicly available and effective for three years.

Editor's Note: See the summary of remarks by Craig C. Olinger on FIRE. Regarding XBRL see the summary of remarks by John W. White.

Communications and Transparency

Mr. Carnall discussed several ways that the Division has improved its internal communication efforts, as well as those externally with registrants, accounting firms, investor groups, and other organizations.

He noted outreach activities by the Division, such as "Dear CFO" letters regarding Statement 157, for which the staff received favorable feedback. Mr. Carnall stated unequivocally that the letters do not change GAAP.

Editor's Note: See the summary of remarks by Stephanie L. Hunsaker on the "Dear CFO" letters, and see Deloitte's *Financial Reporting Alert* 08-10, SEC Advises Registrants to Further Explain Fair Value in MD&A — An Addendum to the March 2008 SEC Letter.

He also noted the SEC staff's participation in the Forums on Auditing in the Small Business Environment hosted by the PCAOB.

Editor's Note: The materials from the forums, including detailed speaker notes, are published on the SEC's Web site in SEC Staff Review of Common Financial Reporting Issues Facing Smaller Issuers. Although the title refers to "smaller issuers," certain guidance in this document can apply to any registrant, such as the overview of the Division, key SEC and U.S. GAAP developments, the comment letter process, and financial reporting issues frequently raised in comment letters.

Mr. Carnall stated that the SEC staff receives numerous phone calls during the year and can always be reached by phone to discuss issues. In addition, to allow for more effective and efficient communication, registrants may now submit questions through the SEC's Web site or by e-mail. He mentioned that the SEC staff will almost always respond to any questions submitted electronically by phone and that the SEC staff's responses are not considered official interpretations of the SEC staff.

Mr. Carnall further noted that the Division has the following new e-mail address for submitting official communication on pre-filing letters (such as requests for waivers of financial reporting requirements): dcaoletters@sec.gov.

Editor's Note: Registrants wishing to submit a request to the SEC staff for interpretive or other assistance can complete the Corporation Finance Request Form for Interpretive Advice and Other Assistance on the SEC's Web site.

Registrants should continue to submit pre-filing letters in writing to the Division and the SEC staff will respond in writing. The staff's policy has not changed in this regard, only the e-mail address has.

Mr. Carnall mentioned that registrants should continue to file their responses to SEC staff comment letters on EDGAR. Registrants should submit only **one** copy of the response letter via EDGAR and not file additional copies by mail and fax, as this may slow down the process.

Mr. Carnall also announced the publication of the Division of Corporation Finance *Financial Reporting Manual* (the "Manual"). The Manual supersedes *Division of Corporation Finance Accounting Disclosure Rules and Practices: An Overview* (the "staff training manual"), which was last updated in 2000. Mr. Carnall noted that although the Manual is intended for use by the SEC staff, it provides useful insights for registrants and therefore has been posted to the SEC's Web site. The SEC staff intends to update the Manual periodically, will post changes in the "What's New" section of its Web site, and will indicate the date of the last update in each section of the Manual.

Editor's Note: In a separate speech, Mr. Olinger indicated that the "Foreign Private Issuers & Foreign Businesses" section of the Manual does not yet cover the recent FIRE release. He expects this to be addressed in the Manual's first update.

In response to questions about whether the Manual reflects substantive changes in the staff's views or conclusions, Mr. Carnall noted that the Manual is significantly expanded and contains roughly twice as much information as the previous document, making side-by-side comparisons difficult, but that changes to the staff's views or conclusions were limited. He mentioned that one change related to gains or losses on the disposal of equity method investees in the determination of whether the equity method investee is significant under Rules 3-09 and 4-08(g) of Regulation S-X. He noted that if a registrant does not retain an investment in the investee or as a result of the disposal accounts for the investee under the cost method, any gain or loss on disposal can now be excluded from the numerator of the income test of significance under Rule 1-02(w) of Regulation S-X. Mr. Carnall also mentioned that the SEC staff is looking at other aspects of how this significance test should be calculated.

Editor's Note: As indicated in section 2410.2(d) of the Manual, a registrant must include in the significance test any gain or loss from a disposition of an interest in a tested equity method investee that is accounted for under the equity method both before and after the disposition. Any other gains or losses arising from dispositions of interests in the tested equity method investee may be excluded from the numerator.

Review Process

Mr. Carnall shared some of his observations on filing reviews. He referred to guidance on the SEC's Web site that explains the review process and provides names and phone numbers of people to call with questions. (See Filing Review Process on the SEC's Web site.) Mr. Carnall noted that the SEC staff is applying the **same** level of diligence to its review of financial statements prepared under IFRSs that it applies to those prepared under U.S. GAAP. He also observed that some registrants are inappropriately using IFRSs to support U.S. GAAP accounting. On another topic, Mr. Carnall briefly mentioned materiality and noted that a complete company-specific analysis with respect to SAB 99 (materiality) should be prepared.

Editor's Note: See the summary of remarks by Mark S. Mahar for an additional discussion about materiality.

In addition, Mr. Carnall noted that the SEC staff continues to ask questions about segment reporting and may request information provided to the chief operating decision maker. He also mentioned that disclosure in the Management's Discussion and Analysis section should reflect the current economic environment.

In response to a question, Mr. Carnall reiterated the guidance regarding third-party consents addressed in Question 141.01 and Question 141.02 of the Compliance and Disclosure Interpretations on Securities Act Sections. Question 141.02 addresses whether a registrant that chooses to refer to a third-party expert must name the third party and obtain the third-party's consent, and makes a distinction between statements of the registrant (in which management is assuming responsibility), which do not require a consent, and statements attributed to a third-party expert, which would require a consent. Mr. Carnall noted that the disclosure provided in the response to Question 141.02 may prove useful to registrants.

Editor's Note: In the slides that Mr. Carnall used in his presentation, a bullet point in slide 29 stated, "Form S-8 — change in financial statements that require retroactive application." Mr. Carnall did not address this point in his remarks or during the subsequent question-and-answer session. However, the following SEC staff position is excerpted from the minutes of the July 8, 2008, SEC Regulations Committee:

> The staff understands that there has been confusion regarding the need to provide restated financial statements in a Form S-8 for certain events occurring after the filing of a Form 10-K that result in differences between the financial presentation in the Form 10-K and subsequent Form 10-Qs that are incorporated by reference into the S-8. . . . It is the responsibility of the Company and their counsel to determine if there has been a material change that is required to be disclosed in a Form S-8. Likewise, it is the responsibility of the auditor to determine if they will issue a consent to the use of their report if there has been a change in the financial statements that is reflected in the 10-Q but the annual accounts have not been retroactively restated.

Filing Review Statistics

Mr. Olinger cited the following statistics regarding reviews that the Division performed for the fiscal year ended September 30, 2008:

- The Division reviewed approximately 4,830 issuers, or 38 percent of all issuers (a slight increase over the previous year).
- Of the total reviews, 435 involved initial public offerings (down from 550 in the previous year).
- The average time between filing a registration statement and receiving initial comments was 25.2 days (down from 25.5 days in fiscal year 2007).

Editor's Note: In response to a question, Mr. Olinger noted that a comment letter may not be issued if the Division staff concludes after its review that there are no material issues to be addressed. In such a situation, the registrant will not be notified that a review was performed by the SEC staff.

Speech by Michael J. Fay, *Associate Chief Accountant*, Division of Corporation Finance of the SEC

The slides that Mr. Fay used in his presentation are posted on the AICPA's Web site (see slides 75–88).

Topics Covered	Affects
• Liquidity and capital resources section of MD&A	SEC registrants

Mr. Fay discussed the importance of the liquidity section of Management's Discussion and Analysis (MD&A) in the current market environment as well as factors registrants should consider in preparing for their upcoming filings.

Mr. Fay reminded registrants that Item 303(a)(1) of Regulation S-K requires the identification of known trends and uncertainties that affect liquidity. This requirement is critical to an informative discussion; however, it is not frequently identified by registrants. He also referred to two interpretive releases[2] that provide excellent guidance on preparing the liquidity section.

Throughout his remarks, Mr. Fay identified the following themes:

- He used the phrase "through the eyes of management" to highlight the importance of providing management's insight in the liquidity section.
- He suggested that a registrant should discuss the liquidity section in terms of its bills (e.g., cash paid to employees, suppliers, shareholders, and banks) and how it will pay them (e.g., cash received from customers, borrowed funds, interest, and dividends).

In addition, Mr. Fay identified the major captions within the liquidity section as well as the typical disclosures within each caption. He believes that registrants can greatly enhance the disclosures' usefulness to investors by discussing the following:

Introductory Discussion

Registrants often use "boilerplate" disclosure when describing whether sources of cash will be sufficient in the future. Mr. Fay recommended that a registrant include (1) the extent to which cash received from customers will meet operating needs, (2) plans to use cash in banks, and (3) the extent to which a registrant will use financing to meet operating needs. Mr. Fay also proposed that the registrant highlight how these expectations are consistent with or different from its historical practices.

Operating Activities

Registrants often focus on changes in line items of the indirect method of cash flows when discussing their cash flows from operating activities. However, Mr. Fay believes that this method may cause critical information to be lost and trends to be overlooked. He believes that registrants should focus more on actual cash received from customers and cash paid

[2] The 1989 and 2003 MD&A interpretive releases (section III.C of FR-36 and section IV of FR-72).

to suppliers. Furthermore, he indicated that registrants should discuss known trends and uncertainties when discussing operating cash flows. He noted that many items underlying known trends and uncertainties apply to all companies. These items include new product releases, competing product introductions, maturing product lines, changing prices, rising costs, and changing payment and credit terms.

Investing Activities

Registrants commonly disclose the amount spent for capital expenditures in the prior year and the amount expected to be spent in the upcoming year. While such information is valuable, Mr. Fay does not believe it constitutes a complete picture. He noted that capital expenditures represent bills and that disclosure should include how capital expenditures will be funded.

Mr. Fay suggested that registrants discuss the extent to which (1) cash received from customers will be sufficient to meet capital requirements and (2) other funding sources will be required. In addition, he recommended that registrants discuss capital expenditures on a discretionary and nondiscretionary basis, especially in times of distressed liquidity conditions. Such disclosures would give investors insight into the minimum expenditures needed to run the business. A registrant should also consider discussing the reasonably likely implications to the business when it chooses, or is required, to reduce capital spending.

Financing Activities

Registrants typically disclose the unused availability on a short-term credit arrangement but do not include analysis that would enable an investor to gauge the historical and future importance of the credit facility to the registrant. Mr. Fay suggested that registrants consider disclosing the extent to which they use the credit facility; excess availability at peak borrowing times; uncertainties precluding a registrant's access to the facility, whether due to market or company-specific conditions; and implications of a registrant's inability to access the facility. Mr. Fay believes that these disclosures would represent a more complete picture of how a company pays its bills.

Credit Ratings

Registrants often disclose their credit ratings without including analysis or context that is sufficiently meaningful to investors. Mr. Fay indicated that when the registrant does not expect a credit rating downgrade in the foreseeable future, it should consider discussing the basis for this determination. However, when a negative change in its credit rating is foreseeable, a registrant is expected to discuss the reasonably likely implications of this change to future liquidity, including immediate effects such as an early cash settlement on a debt provision, higher borrowing costs, and reduced access to capital.

Financial Covenants

Registrants frequently provide a one-sentence statement that they are in compliance with their debt covenants. Mr. Fay suggested that registrants include a statement that compliance is expected in the near and long term and a brief basis for this conclusion. He also indicated that registrants should identify and discuss any known trends or uncertainties that may affect future compliance. In addition, when a breach of a financial covenant is reasonably likely, a registrant is encouraged to discuss whether the breached debt (1) can be avoided or cured, or (2) can be refinanced. The registrant should also identify any cross-default provisions and discuss whether the breach will cast doubt on its future viability. Merely stating there may be a material impact on liquidity is not informative and registrants should carefully address reasonably likely implications.

Additionally, registrants often state that certain financial covenants limit their ability to incur additional indebtedness without discussing the potential effects of these limitations on their liquidity. Mr. Fay recommended that if it is reasonably likely that the covenant will affect liquidity, a registrant should discuss the amount that can be raised, the amount needed, and the implications of a shortfall. If the registrant does not expect the covenant to affect liquidity, it may explain the basis for this determination. If the covenant does not impact liquidity, a registrant may decide reference to it is not necessary.

Current Market Conditions

Mr. Fay indicated that registrants should comprehensively discuss the impact of market events in their liquidity section. Mr. Fay suggested that if it is uncertain that a registrant will have liquidity when it is required, the registrant should give management's insight into the discussions and address any material and reasonably likely implications of its inability to access sources of funding. Regarding future pension funding, a registrant should discuss any uncertainties surrounding the

future amount it will be required to pay and whether it can pay this amount. Mr. Fay also remarked that a registrant should consider discussing any uncertainty in its ability to repurchase shares and pay dividends.

General

Mr. Fay offered general recommendations for improving the clarity of the information in the liquidity section. He recommended that someone unfamiliar with the registrant's financial statements read the liquidity section and give feedback on whether it is informative and whether it presents a good understanding of the registrant's bills and how it will pay them. Mr. Fay also suggested that registrants present context for any important amounts.

> **Editor's Note:** See also the summary of remarks by Arnold C. Hanish, Brian J. Lane, and Pamela A. Long.

Speech by Stephanie L. Hunsaker, *Associate Chief Accountant*, Division of Corporation Finance of the SEC

The slides that Ms. Hunsaker used in her presentation are posted on the AICPA's Web site (see slides 34–60).

Topics Covered	Affects
• Best practices for fair value MD&A disclosure	SEC registrants with significant financial assets/liabilities measured at fair value

Fair Value Disclosures

Ms. Hunsaker discussed the importance of providing transparent disclosures about the use of fair value in SEC filings and recapped recent steps taken by the Division of Corporation Finance (the "Division") to encourage such disclosure. She described two "Dear CFO" letters sent to approximately 30 financial institutions in March and September 2008 in an effort to increase transparency. These letters have been posted to the SEC's Web site.

> **Editor's Note:** For more information about these two letters, see Deloitte's *Financial Reporting Alert* 08-7, SEC Advises Registrants to Further Explain Fair Value in MD&A, and *Financial Reporting Alert* 08-10, SEC Advises Registrants to Further Explain Fair Value in MD&A — An Addendum to the March 2008 SEC Letter.

The letters cover a wide range of topics and are in the form of suggestions. However, a registrant may need to disclose many of these items to comply with Item 303 of Regulation S-K (particularly in circumstances in which fair value measurements are identified as critical accounting estimates). The Division received positive feedback from registrants regarding the letters, especially because they were not specific to a particular registrant and provided a basis for discussion of disclosures with top management. Results from an informal staff study suggested that registrants did increase their fair value disclosures to some extent in response to these letters. Ms. Hunsaker encouraged registrants to provide even more disclosure (such as sensitivity analysis) in upcoming filings.

Best Practices for MD&A Disclosure

To further her encouragement of more disclosures regarding fair value, Ms. Hunsaker presented the following "Top Ten List — Best Practices for Fair Value MD&A Disclosures." These practices are enhancements to the minimum disclosures already required by Statement 157.

10. *Provide more transparent disclosures about transfers into or out of Level 3.*

> **Editor's Note:** Paragraph 32(c) of Statement 157 requires a reconciliation of the beginning and ending balances for all Level 3 measurements. As part of this reconciliation, transfers into or out of Level 3 must be disclosed; registrants typically make this disclosure on a net basis.

Ms. Hunsaker noted the following best practices for disclosures about transfers into or out of Level 3:

- Disclose the entity's policy for transfers into or out of Level 3 (e.g., a policy for transferring in at the beginning of the period and out at the end of the period). If a registrant's policy is to transfer in at the end of the period, disclose the gain/loss for instruments transferred into Level 3, since it will not be reflected in the rollforward.

- Disclose transfers into and out separately in the Level 3 rollforward or provide amounts on a gross basis in a footnote to the table.
- Quantify the gain or loss for each instrument or group of instruments transferred into Level 3 separately during the period.

Example

One way the registrant could quantify the gains or losses is to summarize them in a table. This table could show, by instrument type transferred into Level 3 (i.e., available-for-sale securities or derivatives), (1) whether such amounts were recorded in other comprehensive income or net income and (2) gross transfers. Investors would thus be able to understand what types of instruments were transferred in and the relative gain or loss by instrument type.

9. *When transfers into Level 3 occur, discuss the specific inputs that became unobservable during the period that resulted in the transfer.*

This disclosure could help investors understand what changes resulted in the transfer and what potential future changes could cause those assets or liabilities to become a Level 1 or 2 measurement. It may also help investors compare the registrant's transfers with those of other entities.

8. *For **all** Level 3 measurements, discuss the key drivers of fair value for each significant asset or liability grouping and whether each driver is observable or unobservable.*

Many registrants generically disclose that an item could be classified as Level 3 even though there are key drivers of value that are observable. Additional disclosure of the key drivers and whether they are observable reassures investors about the registrant's fair value measurements and judgments.

Example

The key drivers for auction rate securities could be (1) leverage in the structure, (2) credit rating, and (3) liquidity considerations. A registrant holding an investment in auction rate securities should consider disclosing these key drivers, including which of these inputs are observable and which are unobservable.

7. *Discuss in more detail how the registrant considered illiquidity in the valuation, including the specific assumptions used and how they were developed.*

A registrant may state that the value of an instrument is affected by illiquidity but that there are no credit issues. In these circumstances, a registrant may change its assumptions used in a fair value measurement as values decline from period to period because of further illiquidity. It would be helpful for such a registrant to describe how and why the assumptions have changed. If the registrant changes a valuation technique to compensate for lack of liquidity in the market, it should disclose this fact and indicate how the new technique captures the lack of liquidity.

Example

If a registrant increases the discount rate used in a discounted cash flow analysis to compensate for the effect of illiquidity, it should consider disclosing that fact, the assumption used, and how it changed the value of the asset or liability.

6. *Provide quantitative disclosures of the effects of both the entity's own and counterparty credit risk in valuing derivative assets and liabilities.*

Editor's Note: Registrants must disclose the amount of gain or loss from fair value changes attributable to credit risk for liabilities reported at fair value under the Statement 159 fair value option (FVO). However, there is no such requirement for non-FVO assets or liabilities, such as derivatives. While Ms. Hunsaker discussed these disclosures in the context of derivatives, we believe that they could be applied to all financial instruments carried at fair value.

Ms. Hunsaker recommended the following best practices:

- Clearly disclose how credit is considered in fair value (e.g., on the basis of LIBOR plus a credit default swap spread).
- Separately quantify the effect on net income of the entity's own credit versus counterparty credit and give cross-references to other disclosures required by Statement 159 to make disclosures about the effect of credit more transparent.
- Disclose the effect of credit adjustments on the balance sheet, not just the effect on the income statement.

- Discuss events that affect credit adjustments and any material changes during the period (e.g., credit default swap spreads for many financial institutions that are narrowed upon receipt of TARP funds or other events).
- If there are groups of counterparties that have a material effect on the entity's credit adjustments, consider quantifying that credit effect separately.
- Describe how credit risk is monitored and managed.

5. *Provide disclosure of collateral underlying mortgage backed securities, collateralized debt obligations, collateralized loan obligations, and other similar securities.*

Collateral can vary dramatically by the type of security and can significantly affect fair value and the range of future potential loss. The more detailed aspects of collateral, such as types of loans, vintage information, and the effects of credit enhancements, can also affect fair value. Ms. Hunsaker presented tabular disclosure examples that show the type of security, vintage information, credit ratings (e.g., AAA) and enhancements (e.g., collateral), and the related fair value and amortized cost basis of the security (if applicable). She noted that a table may be the best way to present this information because it can show a large amount of data. The following is a sample table. (See above for a link to Ms. Hunsaker's slides for additional examples).

Collateralized by Subprime Mortgages — September 30, 2008					
Vintage	AAA	AA	Below Investment Grade	Total Fair Value	Total Amortized Cost
2007					
2006					
2005					
2004 and prior					
Total					

4. *Provide additional information about the use of broker quotes and pricing services.*

Although not required to do so, many registrants disclose the use of brokers and pricing services. The following are best practices for providing such disclosures:

- Quantify the extent of the use of brokers and pricing services separately. Brokers are typically only used when pricing services are not available or are unable to provide a quote. Broker quotes may be based on less observable inputs and may be subject to fewer validation procedures.
- Separately discuss the validation procedures performed for each type. This discussion should include how often procedures are performed, the type of personnel involved, and the processes in place to challenge such information.
- Discuss whether prices or quotes are adjusted or overridden. If so, discuss other information used, the level of reviews and approvals, and the impact on the financial statements of using such alternative values.
- Discuss key judgments and the range of values received from brokers and pricing services in arriving at the fair value used in the financial statements.
- Discuss the number of quotes obtained (if multiple quotes were received, discuss how the fair value used in the financial statements was determined). Also, discuss whether the quotes were binding or nonbinding.

3. *Separate the causes of other-than-temporary-impairments (OTTI) on available-for-sale securities between (1) credit related issues or other adverse issuer conditions and (2) other accounting consequences (e.g., entity can no longer assert intent and ability to hold).*

This disclosure will give investors insight into why any impairment charges are being taken.

2. *Additional disclosure about alternative valuation techniques for measurements of Level 3 assets and liabilities.*

For certain illiquid instruments, some registrants disclose that the amounts recorded, which were based on valuation models or broker quotes, could differ materially from amounts that may actually be realized in a current sale. In these circumstances, best practices include:

- Quantify the difference between observed transactions in an inactive market and the amount recorded, to the extent possible.
- Consider discussing how and why the technique used was chosen and the amounts recorded in the financial statements.
- Discuss the strengths and weaknesses of the technique used, comparing it with other alternatives and disclosing why it was the most consistent with Statement 157's measurement objective.

Editor's Note: We believe that this best practice addresses situations described in FSP FAS 157-3 in which observable market transactions may not be determinative of fair value. This might be the case when the volume and level of trading activity in the asset have declined significantly, the available prices vary significantly over time or among market participants, or the prices are not current. For more information about FSP FAS 157-3, see Deloitte's October 13, 2008, *Heads Up*, FASB Issues Guidance on Measuring Fair Value of Financial Assets in an Inactive Market.

1. *Provide a sensitivity analysis, particularly when changes to estimates and assumptions used in estimating fair values of the instrument may result in materially different results.*

Section 5 of FR-72 and paragraph 27(c) of IFRS 7 (by analogy) provide guidance on disclosing a sensitivity analysis. Ms. Hunsaker pointed out that although registrants' use of sensitivity analyses appears to be limited, this disclosure could prove particularly useful to investors.

The following are best practices for sensitivity disclosures:

- Base the sensitivity on reasonably likely inputs as of the balance sheet date (in lieu of a "bright-line" 10 percent increase or decrease in the assumption used).
- Give context for the sensitivity analysis by disclosing the actual assumptions used in the valuations included in the financial statements.
- Provide forward-looking sensitivities that present the potential effect of a future occurrence on the financial statements.

Example of Forward-Looking Sensitivity Analysis

A registrant may disclose that the fair value measurement of its credit derivatives is sensitive to credit downgrades in the underlying reference obligations. The registrant could also provide the quantitative effect of a downgrade in credit rating for each instrument. A best practice is to provide this information on the basis of a reasonably likely downgrade for each instrument rather than a default assumption for all instruments.

Editor's Note: During a subsequent question-and-answer session, Craig C. Olinger indicated that these recommendations were not intended to amend GAAP (Statement 157) and were intended for MD&A disclosure.

However, we believe that registrants may consider combining this information with their Statement 157 disclosures in the footnotes to their financial statements, when appropriate.

Speech by Mark Mahar, *Associate Chief Accountant*, Office of the Chief Accountant of the SEC

The full text of Mr. Mahar's speech is available on the SEC's Web site.

Topics Covered	Affects
• Materiality	SEC registrants and their auditors

Mr. Mahar clarified how the SEC staff applies SAB 108 in situations in which financial statements can be restated in a registrant's next filing rather than via an amendment to the previous filing or filings. Mr. Mahar noted that some registrants and auditors have interpreted Question 2 of SAB 108 to mean that if "the effect of correcting the error that exists in each balance sheet materially impacts the income statement of each year, then the registrant must amend those previously filed financial statements." He noted this is "not how the SEC staff applies SAB 108." Referring to the example in Question 1 of SAB 108, Mr. Mahar pointed out that although an out-of-period correction of the cumulative balance sheet error in any particular year might have been material, if the effect of the error on the balance sheet and income statement is not material to any given period, the restatements would not materially alter the previous financial statements, as reported, and those financial statements could still be relied upon. Therefore, the entity could include the restatement in the next filing without having to amend the previous filing.

Editor's Note: The SEC staff has clarified that when a registrant assesses prior-period misstatements and determines whether a restatement can be included in the next filing without its having to amend the previous filing, the registrant needs to consider the rollover effect of such misstatements on the income statement rather than consider the effect of both the rollover and the iron curtain approach on the income statement.

Mr. Mahar concluded his remarks on materiality with a discussion of some of the recommendations by the SEC Advisory Committee on Improvements to Financial Reporting (CIFiR) and SAB 99. CIFiR has recommended that materiality be considered from the perspective of the reasonable investor on the basis of the total mix of information. That objective should be kept in mind when materiality of errors is considered. He noted that CIFiR's recommendations, as well as the Supreme Court's view that the concept of the total mix of information applies regardless of the magnitude of the errors, are consistent with the SEC staff's views. He also noted that although the "relative magnitude is itself a factor and may provide a basis for a preliminary view, the staff does not exclusively rely on numerical or percentage based bright-lines."

Mr. Mahar noted that assessments of materiality require judgment and should include the performance of a robust analysis that identifies factors that are significant to investors' decisions. Assessments should not be limited to the factors discussed in SAB 99 because those factors are not all inclusive, nor are they intended to preclude the conclusion that quantitatively larger errors are immaterial. He noted the following factors that are not specified in SAB 99 and stated that there could be additional factors:

- "Company specific trends and performance metrics that may influence investment decisions."
- The effect of an unrelated circumstance on a factor that is important to a reasonable investor, such as an error in the income statement that is magnified simply because it occurs "during a period in which net income is abnormally small" relative to historical and expected trends.

Editor's Note: In a question-and-answer session, Wayne E. Carnall was asked for an example of when it might be reasonable to conclude that a quantitatively large error might not be material. He emphasized that two companies with errors that have exactly the same effect on net income could reach different conclusions — in "one situation it could be material and the other situation it could be immaterial." He gave an example of a registrant that had an out-of-period error related to a change in tax rate. He noted that the disclosures were very transparent, disclosing the nature of the error and quantifying the amount of the error. The SEC staff did not object to the registrant's and the auditor's conclusion that the error was not material. He then indicated, however, that if the error had been of the same magnitude and had the same effect on net income, but had related to revenues and the sustainability of revenues, the SEC might have come to a different conclusion. He stated that there is "no silver bullet but that it is a matter of looking at all the facts behind the issue."

He also noted that "the total mix of information and how a reasonable investor might consider such information" should also be used to evaluate the materiality of errors in interim financial information.

Editor's Note: Paragraph 29 of APB Opinion 28 provides guidance on the evaluation of the materiality of errors in interim financial statements.

Speech by Robert C. Pozen, *Chairman*, SEC Advisory Committee on Improvements to Financial Reporting

Topics Covered	Affects
• Recommendations in the final CIFiR report to the SEC	Preparers, auditors, regulators, and users of financial statements

Mr. Pozen discussed the final report of the SEC Advisory Committee on Improvements to Financial Reporting (CIFiR) and highlighted some of its recommendations. The report was released on August 1, 2008, and outlines 25 recommendations for reducing complexity in financial reporting and increasing the usefulness of financial information to investors. CIFiR's research was broad, and its recommendations covered a variety of processes that affect U.S. SEC registrants, including standard setting, regulatory oversight, and delivery of financial information.

Editor's Note: See Deloitte's August 1, 2008, *Heads Up*, Complexity DeCIFiRed — SEC Advisory Committee Releases Final Report.

Mr. Pozen provided additional insight into his views on several recommendations, including the increase in the exercise of professional judgment and the reduction in the number of restatements.

Professional Judgment

When preparing and auditing financial statements, accountants must exercise judgment. However, because judgment is subjective, CIFiR has recommended that the SEC adopt a policy statement that would provide more transparency on how regulators evaluate the reasonableness of a judgment. CIFiR also recommends that judgments be documented contemporaneously to ensure that the evaluation of the judgment is based on the same facts that were reasonably available when the judgment was made. That documentation should help others understand the rationale for the alternative chosen. Mr. Pozen expressed optimism that the SEC will provide guidance in the near future on a professional judgment framework.

Editor's Note: See the summary of remarks by Robert G. Fox III. Mr. Fox discussed judgment regarding accounting matters with reference to the CIFiR report.

Reduction of Restatements

CIFiR also considered recommendations aimed at reducing the number of restatements. Restatements have increased significantly over the past several years. Mr. Pozen indicated that he believes this increase has diluted the intended purpose of restatements and diminished the interest of investors. To reduce the number of "less meaningful" restatements, CIFiR is recommending that the SEC modify how the materiality of an error is assessed and change how certain errors are corrected. CIFiR believes that all accounting errors, other than clearly insignificant errors, should be corrected and disclosed in the current period; however, all errors should not result in a restatement. Financial statements should only be restated if the error is material to investors making current investment decisions and would affect an investor's expectations about future performance of the entity.

Editor's Note: Implementation of CIFiR's recommendations does not require legislative action. The SEC has addressed two of the recommendations, XBRL and the use of corporate Web sites, in a proposed rule and an interpretive release, respectively.

Speeches by:

Arnold C. Hanish, *Vice President and Chief Accounting Officer*, Eli Lilly and Company

Brian J. Lane, *Partner*, Gibson, Dunn & Crutcher LLP

Pamela A. Long, *Assistant Director*, Division of Corporation Finance of the SEC

Topics Covered	Affects
• MD&A	SEC registrants

Emphasizing liquidity analysis, Ms. Long noted three reminders for registrants to consider as they prepare Management's Discussion and Analysis (MD&A) in their upcoming filings:

- Registrants should focus on material trends and uncertainties. Trends must be disclosed unless an event is not reasonably likely to occur or a material effect on a company is not reasonably likely to occur as a result of the event. Assessing whether something may be "reasonably likely" to occur may be more difficult when current market conditions are taken into account.
- Registrants should focus on the *analysis* in MD&A. Often registrants do not provide sufficient analysis of the reasons underlying matters described in MD&A. Registrants should ensure that their liquidity analysis sufficiently discloses the "why?"
- Numerous items would improve disclosure in the liquidity and capital resources section of MD&A. This section should focus on the company's known material cash requirements and commitments. Registrants should disclose their sources of cash, such as operating cash flows, material financing arrangements, debt instruments, guarantees, financial covenants that appear in the company's debt instruments, and cash management policies.

Editor's Note: See the summary of remarks by Michael J. Fay. Mr. Fay discussed the importance of the liquidity section and provided observations and considerations for registrants as they prepare for their upcoming filings.

Ms. Long indicated that registrants should disclose their debt covenants if they (1) are in breach of a covenant, (2) are reasonably likely to be in breach of a covenant, or (3) have covenants that limit their ability to access other financing. She further indicated that if it is reasonably likely that an event may occur that would cause a covenant to be breached, and the breach would have a material effect on the company, the covenants should be discussed in the liquidity section.

Editor's Note: In a later question-and-answer session, Ms. Long was asked how much specific detail should be provided about debt covenants. She indicated that when registrants disclose the covenants, they should generally provide numerical disclosures of the required and actual ratios in MD&A.

In the question-and-answer session, Ms. Long encouraged registrants to call their examiners when they have questions about the comments and the nature and amount of the disclosures requested. Also see the "Reconsideration Process" described in an overview of the Filing Review Process on the SEC's Web site.

Ms. Long also shared some observations about how to improve the liquidity section in light of the current economic conditions. She indicated that such improvements have been and will continue to be a focus by her staff. First, she reminded registrants of the need for enhanced discussion of impairments. Second, she noted that when a registrant has a restructuring charge, it should disclose (1) material costs of the restructuring, (2) when the costs are expected to be taken, and (3) how the costs will be paid for. Third, she indicated that registrants should discuss the basis for concluding that they will realize deferred tax assets. Lastly, Ms. Long stated that registrants should provide a thorough discussion of the ongoing and expected future impact of the current market conditions on the significant estimates and assumptions that underlie pension income and plan assets, and whether additional cash contributions to plans are required.

Editor's Note: See the summary of remarks by Steven C. Jacobs. Mr. Jacobs discussed goodwill impairment disclosures as well as disclosures on deferred tax assets and the valuation allowance.

Mr. Lane outlined the following tips for registrants to consider when preparing MD&A, particularly in light of the current market conditions:

- Use plain English and avoid the use of legal jargon.
- Provide an effective executive summary to highlight the material events and changes in the current period.

- Provide better *analysis* — registrants can do so by adding a "why" at the end of each sentence in MD&A as initially drafted and adding information to address those questions.
- Quantify the effect of multiple factors that contribute to the overall change in a financial statement line-item.

Mr. Lane discussed areas of SEC staff focus and read from comment letters issued by the staff of the Division of Corporation Finance. He indicated that he expects to see new risk factors that may include the following: liquidity, asset write-downs, consumer spending, government programs, changes in regulation, fuel price susceptibility, real estate "bubble" exposure, counterparty risk, market risk, and climate control.

Editor's Note: See Deloitte's SEC Comment Letters on Domestic Registrants for additional information.

Speeches by:

Craig C. Olinger, *Deputy Chief Accountant*, Division of Corporation Finance of the SEC

Allison M. Patti, *Professional Accounting Fellow*, Office of the Chief Accountant of the SEC

The slides that Ms. Patti used in her presentation are posted on the AICPA's Web site.

Topics Covered	Affects
• Foreign private issuer statistics • Rulemaking • Other reporting issues • IOSCO initiatives	Foreign private issuers

Foreign Private Issuer Statistics

Mr. Olinger discussed the current population of foreign private issuers (FPIs). As of December 31, 2007, there were 1,058 FPIs, a 15 percent decline from December 31, 2004. Mr. Olinger estimated that about 400 FPIs use Canadian GAAP reconciled to U.S. GAAP, about 300 use U.S. GAAP, about 100 use IFRSs as issued by the IASB, and the remaining FPIs use home-country GAAP reconciled to U.S. GAAP.

Rulemaking

Final Rules

Mr. Olinger cited several FPI-related final rules that the SEC has adopted over the past year:

- Commission Guidance and Revisions to the Cross-Border Tender Offer, Exchange Offer, Rights Offerings, and Business Combination Rules and Beneficial Ownership Reporting Rules for Certain Foreign Institutions.
- Exemption From Registration Under Section 12(g) of the Securities Exchange Act of 1934 for Foreign Private Issuers.
- Foreign Issuer Reporting Enhancements (FIRE).
- Acceptance From Foreign Private Issuers of Financial Statements Prepared in Accordance With International Financial Reporting Standards Without Reconciliation to U.S. GAAP.

FIRE amends the disclosure requirements for FPIs and stipulates the dates of compliance with each of the requirements, starting in 2009. Mr. Olinger summarized the eight individual revisions to Form 20-F addressed in FIRE. The following two amendments are particularly noteworthy:

- *Acceleration of the annual report deadline* — FIRE changes the filing deadline for annual reports of FPIs from six months to four months after fiscal year-end, beginning with fiscal years ending on or after December 15, 2011. Mr. Olinger clarified that the rule did not change the age-of-financial-statement requirements for registration statements.

- *Disclosure of change in accountants* — FIRE requires FPIs to disclose changes in and disagreements with their certifying accountants in a Form 20-F, beginning with filings for fiscal years ending on or after December 15, 2009. Mr. Olinger mentioned that these requirements are almost the same as those in Item 304 of Regulation S-K. However, a registrant must make this disclosure only annually on Form 20-F or in a registration statement, if filed sooner. Mr. Olinger further clarified that these requirements apply only to a change in accountants on or after December 6, 2008, the effective date of FIRE.

Editor's Note: For more information about FIRE's disclosure amendments, see Deloitte's *Accounting Roundup*: Third Quarter in Review — 2008.

Mr. Olinger then briefly discussed the adoption of Acceptance From Foreign Private Issuers of Financial Statements Prepared in Accordance With International Financial Reporting Standards Without Reconciliation to U.S. GAAP, which became effective on March 4, 2008.

Mr. Olinger indicated that FPIs that are using IFRSs as issued by the IASB in preparing their financial statements are not required to provide the Regulation S-X **financial statement disclosures**. However, he stated that generally, such FPIs must still provide the **non-financial statement disclosures**, such as those required in SEC Industry Guide 3, *Statistical Disclosure by Bank Holding Companies*, as well as disclosures required by Regulation S-K.

In addition, Mr. Olinger pointed out that certain FPIs that currently use U.S. GAAP in their SEC filings but use a different comprehensive basis of accounting in their home jurisdiction may encounter certain implementation issues if they wish to switch to using IFRSs as issued by the IASB in their SEC filings. The SEC staff has not reached a conclusion about which reconciliation disclosures are appropriate in these situations. Further developments will be discussed at future meetings of the International Practices Task Force (IPTF).

Editor's Note: The IPTF is a task force of the SEC Regulations Committee that "meets periodically with the SEC staff to discuss and focus on international emerging technical accounting and reporting issues relating to SEC rules and regulations." Meeting agendas and highlights of issues discussed are available at www.thecaq.org.

Proposed Rules

Mr. Olinger reminded registrants that the proposed rules on XBRL and oil and gas reporting requirements apply to FPIs.

Mr. Olinger also discussed the proposed IFRS "roadmap." Although the roadmap applies primarily to U.S. registrants, it would permit all IFRS issuers (defined in Article 13 of Regulation S-X, as proposed by the roadmap) and all FPIs to file the separate nonissuer financial statements required by Rule 3-05, 3-09, or 3-14 of Regulation S-X, using IFRSs as issued by the IASB without reconciliation, regardless of whether the nonissuer meets the definition of an FPI, an IFRS issuer, or a foreign business.

Editor's Note: As currently drafted, the roadmap's proposed addition of Article 13 of Regulation S-X would apply to all issuers that prepare financial statements in accordance with IFRSs as issued by the IASB for filings with the SEC. Article 13 contains the Commission's most recent views on the interaction between IFRSs and the requirements of Regulations S-X and S-K. Although not yet adopted, Article 13 may be a useful tool for FPIs in determining how to comply with the disclosure requirements of Form 20-F that refer to U.S. GAAP. For additional information on the roadmap, see Deloitte's November 17, 2008, *Heads Up*, SEC Issues Proposed IFRS Roadmap.

Other Reporting Issues

Mr. Olinger clarified the SEC staff's position regarding financial statements required in a Form 8-K after a reverse recapitalization of a nonreporting foreign company into a domestic public shell company. The SEC now requires that the financial statements of the foreign company be presented under U.S. GAAP in the initial Form 8-K. Financial statements in home-country GAAP reconciled to U.S. GAAP are not acceptable.

Editor's Note: For more information on this reporting issue, see Section 6410.4 of the Division of Corporation Finance *Financial Reporting Manual*.

IOSCO Initiatives

Ms. Patti provided an update on task forces that are supporting the various initiatives of the International Organization of Securities Commissions (IOSCO) in auditing, ethics, and independence. One initiative of significance to all registrants relates to IOSCO's potential participation in a proposed monitoring group that would observe the International Accounting Standards Committee Foundation (IASCF). Ms. Patti indicated that this initiative is particularly significant because one of the milestones in the roadmap relates to achieving sufficient accountability and funding of the IASCF. The milestone states that accountability of the IASCF would be improved if a monitoring group were to provide a forum for interaction between securities regulators and the IASCF trustees.

Speeches by:

Julie A. Erhardt, *Deputy Chief Accountant*, Office of the Chief Accountant of the SEC

Liza McAndrew Moberg, *Professional Accounting Fellow*, Office of the Chief Accountant of the SEC

The full text of Ms. Erhardt's speech and the full text of Ms. McAndrew Moberg's speech are available on the SEC's Web site.

Topics Covered	Affects
• Proposed IFRS roadmap	Preparers, auditors, regulators, and users of financial statements

Ms. Erhardt gave her perspective on international financial reporting issues, including whether the SEC should allow or mandate the use of IFRSs in the United States. She discussed the SEC's recently released "roadmap," which outlines milestones that, if achieved, could lead to the mandatory transition to IFRSs starting in fiscal years ending on or after December 15, 2014. She noted that the SEC welcomes constituents' views on whether the roadmap's proposal is the optimal approach or whether there is a better way to proceed. (Comments on the release are due by February 19, 2009.)

Ms. McAndrew Moberg discussed the IFRS roadmap in greater detail, noting that it includes two significant proposals:

- A rule proposal to allow certain U.S. issuers to use IFRSs in their financial statements beginning in fiscal years ending on or after December 15, 2009.
- A concept release containing the milestones and timeline that the SEC will consider in deciding whether to mandate the use of IFRSs for all U.S. issuers.

Echoing Ms. Erhardt's remarks, Ms. McAndrew Moberg cautioned that the IFRS roadmap is only a proposal and does not represent the SEC's official decision that IFRSs will be mandatory for U.S. issuers. She also described broader policy considerations, particularly those related to the overall goal of a single set of global accounting standards. A significant aspect of those policy considerations is the difficulty in evaluating the costs and benefits associated with mandatory use of IFRSs. Ms. McAndrew Moberg encouraged all constituents (issuers, investors, and others) to submit comments to the SEC regarding the costs and benefits of an IFRS conversion.

Editor's Note: The IFRS roadmap indicates that in 2011 the SEC will consider whether U.S. registrants should use IFRSs in preparing their financial statements. The convergence projects in the FASB/IASB Memorandum of Understanding (MOU) are also scheduled for completion on this date. Ms. Erhardt indicated that the selection of this date was not a coincidence; this date represents a "natural break point" at which to assess the future approach to IFRS adoption.

In his speech, James Leisenring highlighted several of the convergence projects on the IASB's agenda. See the summary of remarks by Mr. Leisenring.

INTERNAL CONTROL OVER FINANCIAL REPORTING

Speeches by:

Mark S. Beasley, *Deloitte Professor of Enterprise Risk Management and Professor of Accounting in the College of Management*, North Carolina State University

Joseph V. Carcello, *Ernst & Young Professor in the Department of Accounting and Information Management*, University of Tennessee

Topics Covered	Affects
• Study on fraudulent financial reporting from 1997 to 2007	General information for use by entities and auditors

Mr. Beasley, Mr. Carcello, and others, in conjunction with the Committee of Sponsoring Organizations of the Treadway Commission (COSO), are conducting a study of fraudulent financial reporting that took place from 1997 to 2007. The study is a follow-up to the one COSO published in 1999, *Fraudulent Financial Reporting: 1987–1997 — An Analysis of U.S. Public Companies*.

The speakers explained that the research undertaken for the study involved (1) obtaining and reviewing SEC enforcement actions that alleged violations of the antifraud provisions of the Securities Act of 1933 and Securities Exchange Act of 1934 and (2) gathering certain data about the fraud period, amounts, perpetrators, financial statement accounts involved, methods involved, motivations, and sanctions. The study is focusing on the nature of the frauds, fraud techniques, and individuals involved, as well as the consequences of the frauds. It compares metrics of companies at which fraud was perpetrated to metrics at those with no identified fraud. The metrics compared will include governance characteristics such as board tenure, affiliated directors, and CEO involvement on board committees.

The study, which is still in process, is expected to be published in 2009 and will be available on COSO's Web site.

Speeches by:

Paul Beswick, *Deputy Chief Accountant, Professional Practice*, Office of the Chief Accountant of the SEC

Marc Panucci, *Associate Chief Accountant*, Office of the Chief Accountant of the SEC

The full text of Mr. Panucci's speech is available on the SEC's Web site.

Topics Covered	Affects
• Section 404 compliance issues and internal control disclosures	SEC registrants
• Section 404 implementation cost/benefit study	SEC registrants that are nonaccelerated filers
• Current economic environment's effect on internal control	SEC registrants and registered public accounting firms

Section 404 Compliance Issues and Internal Control Disclosures

Compliance Issues

Mr. Beswick highlighted the following observations by the SEC staff regarding registrants' failure to comply with the SEC's rules and regulations on management's annual report on internal control over financial reporting (ICFR) as required by Section 404(a) of the Sarbanes-Oxley Act:

- *Failure to include management's annual report on ICFR in the filings of certain nonaccelerated filers* — Omitting such required disclosure constitutes noncompliance with Commission rules and also raises questions about the accuracy of management's conclusions about the effectiveness of disclosure controls and procedures when a registrant has indicated that such controls and procedures are effective.

Editor's Note: Disclosure controls and procedures should be designed to ensure that information required to be disclosed by the registrant in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized, and reported within the periods specified in the Commission's rules. Because management's report on its assessment of ICFR is required by the Exchange Act, omission of the assessment or an incomplete assessment (see next bullet) may call into question the effectiveness of disclosure controls and procedures.

- *Failure to properly include all of the required components of management's annual report on ICFR* — Specific examples cited by Mr. Beswick included situations in which management's statement referring to the framework used to evaluate the effectiveness of ICFR was omitted, as well as instances in which management inappropriately referred to the SEC's management guidance or COSO's small-company guidance as the framework used for the evaluation. Mr. Beswick reiterated that the following statements are required to be in management's annual report on ICFR:
  - A statement of management's responsibility for establishing and maintaining adequate ICFR.
  - A statement identifying the framework used by management to evaluate the effectiveness of ICFR.
  - Management's assessment of whether ICFR is effective and a disclosure of any material weaknesses.
  - A statement that the registered public accounting firm that issued the financial statements has issued an attestation report on ICFR for an accelerated filer, or that such a report is not required for a nonaccelerated filer.

Internal Control Disclosures

Mr. Panucci discussed other SEC observations about registrants' disclosures related to ICFR, including:

- Disclosure of material weaknesses.
- Other disclosure observations.

Disclosure of Material Weaknesses

Mr. Panucci indicated that management's disclosures of material weaknesses should go beyond merely identifying the existence of one or more material weaknesses or providing only a limited description. Rather, he indicated that in making such disclosures, registrants should provide enough information to allow investors to understand the cause of a material weakness and determine the pervasiveness of its effect on ICFR.

Editor's Note: Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934 indicates that management should consider the following in its disclosures about material weaknesses:

- The nature of any material weakness,
- Its effect on the company's financial reporting and its ICFR, and
- Management's current plans, if any, or actions already undertaken, for remediating the material weakness.

Other Disclosure Observations

Mr. Panucci also noted that when financial statements are restated to correct a material misstatement, "[m]anagement is not required to reassess or revise its conclusions related to the effectiveness of [ICFR] but management should consider whether its original disclosures are still appropriate and should modify or supplement its original disclosure[s] to include any other material information that is necessary for such disclosures not to be misleading in light of the restatement. [Management] may have concluded [that] a material weakness does not exist, existed but has since been remediated, or still exists as of the current year-end." Mr. Panucci indicated that investors would generally benefit from information on management's judgment in arriving at such conclusions.

Editor's Note: While management is not required to reassess or revise its conclusions on the effectiveness of ICFR, the auditor, in accordance with PCAOB AU Section 561, would need to issue a revised report on the company's ICFR for inclusion in Form 10-K/A if there is a material weakness that was not previously identified. If management does not revise its report to include a description of such material weakness, the auditor should, in accordance with PCAOB Auditing Standard 5, modify his or her report to state that a material weakness has been identified but was not included in management's assessment. To keep the auditor from having to modify his or her report, a registrant usually will elect to issue a revised management report on ICFR, including a description of any newly identified material weakness, and modify the conclusion about effectiveness of ICFR if the previous conclusion was that ICFR was effective.

Mr. Panucci also emphasized the requirement to identify and disclose all material weaknesses and noted that in certain instances, the SEC has observed that management's discussion of the remediation plans has called into question the validity and completeness of management's material weakness disclosures. Sometimes the remediation plans are broader than the disclosed material weakness, which would seem to indicate that the disclosed material weakness is actually more pervasive than that disclosed or that another material weakness may exist that was not identified and disclosed. Mr Panucci suggested while the SEC staff encourages robust disclosure of remediation plans, registrants should consider the root cause of an issue and whether it has a broader impact or highlights a more pervasive issue in the entity's ICFR.

Section 404 Implementation Cost/Benefit Study

Mr. Beswick indicated that the SEC has commenced its study of the costs and benefits of Section 404 implementation. The objective of the study is to determine whether the SEC's management guidance and PCAOB Auditing Standard 5 are achieving the desired effect of reducing the cost of ICFR evaluations and audits. The SEC's study involves broad data gathering and is focused particularly on smaller companies. Part of the study includes requesting companies to participate voluntarily in a Web-based survey.

Editor's Note: Additional information and a link to the study are available on the SEC's Web site.

On June 26, 2008, the SEC adopted an additional one-year extension for nonaccelerated filers to submit auditor attestation reports on ICFR, as required under Section 404(b) of the Sarbanes-Oxley Act, which would make such filings required for fiscal years ending on or after December 15, 2009. At that time, the SEC also announced that it would conduct the cost/benefit study discussed above. During a question-and-answer session, Mr. Beswick indicated that it was too early to ascertain whether the Section 404(b) requirements for nonaccelerated filers would be deferred again. He said that when making a decision on further deferral, the SEC would consider the results of the cost/benefit study and other qualitative factors. The upcoming change of U.S. presidents, among other leadership changes, may also affect whether the deferral is continued.

Current Economic Environment's Effect on Internal Control

Mr. Panucci pointed out that the current economic environment and resulting actions by a company may not only have accounting implications, but may also affect an entity's ICFR structure and its disclosure controls and procedures. He suggested that companies evaluate the effect on ICFR and disclosure controls and procedures when they evaluate the accounting implications, because an integrated approach may help to prevent and detect material misstatements in the financial statements.

As management devotes more time to areas of financial reporting that are particularly likely to be affected by the current market conditions, it may need to consider whether its assessment of the risks of material misstatement of the financial statements has changed (including the risk of fraud), and if so, how those changes affect ICFR and management's evaluation of ICFR. This consideration would include an assessment of:

- The ongoing appropriateness of the design of existing controls to address new or changed risks (e.g., controls relating to development of significant and sensitive estimates and assumptions).
- Whether there is increased risk that controls may not operate as intended (e.g., because there are fewer people to operate the controls as a result of restructurings or terminations).
- Whether more extensive testing is required to produce more persuasive evidence to support management's ICFR assessment.

To the extent that incremental disclosures (e.g., disclosure of risks and uncertainties, liquidity, and credit risks) are necessary because of the current market, management may also need to consider changes to existing disclosures or whether incremental disclosures might also be necessary. Management may therefore need to determine whether existing disclosure controls and procedures are adequate to properly gather the necessary information for such disclosures.

Mr. Panucci noted that in the audit of ICFR, changes in risks associated with financial reporting may also affect the nature, timing, and extent of the auditor's tests of the design and operating effectiveness of ICFR.

AUDIT STANDARD SETTING

Speeches by:

Paul Beswick, *Deputy Chief Accountant, Professional Practice*, Office of the Chief Accountant of the SEC

Jeff Ellis, *Professional Accounting Fellow*, Office of the Chief Accountant of the SEC

Tom Ray, *Chief Auditor and Director of Professional Standards*, PCAOB

Keith Wilson, *Associate Chief Auditor*, PCAOB

The full text of Mr. Ellis's speech is available on the SEC's Web site. The full text of Mr. Ray's speech is available on the PCAOB's Web site.

Topics Covered	Affects
• PCAOB risk assessment standards • Other standard-setting activities of the PCAOB	Preparers and auditors of financial statements

Mr. Beswick noted that as part of its role in overseeing the PCAOB's activities, the SEC considers the standard-setting activities of other bodies. For example, the SEC observes the AICPA's Auditing Standards Board (ASB) meetings and participates on committees of the International Organization of Securities Commissions (IOSCO), which provides input to the International Audit and Assurance Standards Board (IAASB). By observing the activities of these other bodies, the SEC staff has affirmed its views on the importance of objectivity and transparency in standard setting.

Editor's Note: Among other things, the IAASB achieves transparency in standard setting by:

- Having an oversight board.
- Having members that are practitioners and nonpractitioners.
- Holding meetings that are open to observers.
- Posting standard-setting information, including meeting materials, exposure drafts, and final standards, on its Web site.

PCAOB Risk Assessment Standards

Mr. Ellis discussed the PCAOB's approach in drafting the recently proposed standards on the auditor's assessment of and responses to risk. He focused on the following aspects of the approach:

- The relationship to standards of other audit standard setters.
- The drafting conventions used.
- The process followed in drafting the standards.

Editor's Note: For the full text of the standards, see Release No. 2008-006 on the PCAOB's Web site.

Relationship to Other Standards

In connection with the PCAOB's proposed standards, Mr. Ellis noted that the PCAOB's approach to consideration of standards of other audit standard setters brings up the broader discussion of how and to what extent convergence of auditing standards should occur. He explained that in a manner consistent with its strategic plan to consider the work of other standard setters, the PCAOB has indicated that when drafting the proposed standards, it considered the appropriateness of the objectives and requirements in the International Standards on Auditing (ISAs) for U.S. issuers. However, he pointed out that the proposed standards were not drafted to achieve full convergence with the ISAs and that some significant differences exist between the two sets of risk assessment standards.

In addition, Mr. Ellis remarked that (1) convergence is a worthwhile goal if it "promote[s] consistent auditor performance and high quality audits" and (2) ISAs are used in some form or convergence with them is occurring in many jurisdictions, including the United States. Mr. Ellis emphasized this point by explaining that the ASB adjusts, as appropriate, the ISAs for the needs of U.S. nonissuers and the U.S. legal and regulatory environment. For instance, the ASB recently voted to expose its clarified risk assessment standards for comment as part of its plan for convergence with the ISAs. Therefore, the ASB's risk assessment standards generally match those of the IAASB word for word; in certain circumstances, however, the ASB decided to depart from the IAASB's wording to reflect circumstances unique to auditing in the United States.

Editor's Note: The ASB's strategy is to converge its standards with those of the IAASB. This project is combined with a project to address concerns about the length, clarity, and complexity of its standards (see further discussion below). For more information about the ASB's clarity and convergence project, see the pamphlet "Clarification and Convergence" on the AICPA's Web site.

Mr. Ellis encouraged constituents to comment on the PCAOB's and ASB's standards simultaneously (the standards are being exposed during the same time frame) and noted that the PCAOB is seeking "feedback on whether the proposed [risk assessment] standards appropriately consider the provisions of the ISAs."

Editor's Note: Even though both boards are attempting to achieve the same objective (i.e., to converge standards), their drafting approaches are different. By reviewing the ASB and PCAOB proposed risk assessment standards simultaneously, commenters can identify the potential differences and comment accordingly.

Drafting Conventions

Mr. Ellis discussed the drafting conventions used by the PCAOB in preparing the proposed standards. He pointed out that the PCAOB's drafting conventions are similar to the IAASB's in some ways. For example, the PCAOB included an objective for each of the recently proposed standards. This approach is similar to the approach used in the ISAs as well as that taken by the ASB, but is different from the approach used in prior PCAOB standards. He also pointed out that the drafting conventions are quite different in other ways (e.g., the proposed standards include less detailed guidance than the ISAs, the ASB standards, and the PCAOB's interim standards).

Mr. Ellis also noted that the PCAOB has not undertaken a "clarity project" similar to those of the IAASB and the ASB. The objective of these clarity projects is to eliminate the ambiguity in an auditor's requirements and to improve the overall readability and understandability of the standards.

Mr. Ellis emphasized that the PCAOB seeks feedback on whether the standards clearly and comprehensively articulate the principles of the risk assessment process. He encouraged commenters to consider whether the PCAOB standards clearly communicate the application of the principles of the standards and to provide comments accordingly.

Editor's Note: The establishment of objectives for each of the PCAOB proposed standards aligns with the structure of the ISAs and redrafted ASB standards; however, the inclusion of less detailed guidance is inconsistent with these standards. The IAASB's ISA 200 is an overall objectives standard that explains the authority of the objectives in each of the ISAs. The ASB has exposed a proposed SAS that is similar to ISA 200 for public comment. The PCAOB has not proposed a standard to explain the context of the objectives set forth in the currently proposed standards. The PCAOB is soliciting feedback in its exposure draft on its use of objectives in the proposed standards.

Process of Drafting

Mr. Ellis noted that in the PCAOB's open meeting to approve the proposed standards, Board Member Dan Goelzer specifically requested comments regarding the transparency of the PCAOB's standard-setting process. "[D]epending upon the nature of the comments received, additional steps [may be taken by the PCAOB] to promote transparency." The SEC is also interested in comments regarding the transparency of the PCAOB's process and in actions the PCAOB might take to improve the transparency and openness of its standard setting.

Editor's Note: The PCAOB's process for developing its proposed standards includes obtaining input from its Standard Advisory Group. The input from other groups and the public is limited. This is contrary to the IAASB's process, which involves much broader participation from IAASB members and various oversight bodies. The IAASB's process is also visible to a broader range of constituents (e.g., its meetings are open to observers and its meeting materials relating to the development of exposure drafts and finalization of its standards are available on its Web site).

Other Standard-Setting Activities of the PCAOB

Mr. Ray's remarks focused on the PCAOB's standard-setting activities. In addition to discussing the proposed risk assessment standards highlighted above, he addressed the following items:

- The recently released Staff Audit Practice Alert No. 3, which highlights how audit risk is affected in the current environment and how an audit is conducted under current standards.
- The continued relevance of Staff Audit Practice Alert No. 2.
- The release of the Report on the PCAOB'S 2004, 2005, 2006, and 2007 Inspections of Domestic Annually Inspected Firms, which summarizes the PCAOB's inspection findings for the eight largest firms for the inspection years indicated.
- Standard-setting activities, including Auditing Standard 6 and the proposed standards related to the auditor's assessment of and response to risk (PCAOB Release No. 2008-006).

Mr. Wilson discussed certain rules recently adopted by the PCAOB, including the following:

- Amendment of Rule 3523.
- Rule 3526.
- Annual and special reporting rules.
- Reporting rules on succeeding to a predecessor firm's registration status.

Appendix A: Glossary of Standards

FASB Statement No. 161, *Disclosures About Derivative Instruments and Hedging Activities* — an amendment of FASB Statement No. 133

FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements*

FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*

FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans — an amendment of FASB Statements No. 87, 88, 106, and 132(R*)

FASB Statement No. 157, *Fair Value Measurements*

FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*

FASB Statement No. 142, *Goodwill and Other Intangible Assets*

FASB Statement No. 141(R), *Business Combinations*

FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*

FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*

FASB Statement No. 128, *Earnings per Share*

FASB Statement No. 87, *Employers' Accounting for Pensions*

FASB Statement No. 57, *Related Party Disclosures*

FASB Statement No. 5, *Accounting for Contingencies*

FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* — an interpretation of FASB Statement No. 109

FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities*

FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* — an interpretation of FASB Statements No. 5, 57, and 107 and rescission of FASB interpretation No. 34

Accounting Research Bulletin No. 51, *Consolidated Financial Statements*

APB Opinion No. 23, *Accounting for Income Taxes — Special Areas*

APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*

FASB Concepts Statement No. 6, *Elements of Financial Statements* — a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2)

FASB Staff Position (FSP) No. FAS 157-3, "Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active"

FASB Staff Position (FSP) No. FAS 140-4 and FIN 46(R)-8, "Disclosures by Public Entities (Enterprises) About Transfers of Financial Assets and Interests in Variable Interest Entities"

FASB Staff Position (FSP) No. FAS 133-1 and FIN 45-4, "Disclosures About Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161"

FASB Staff Position (FSP) No. APB 14-1, "Accounting for Convertible Debt Instruments That May Be Settled in Cash Upon Conversion (Including Partial Cash Settlement)"

EITF Issue No. 08-10, "Selected Statement 160 Implementation Questions"

EITF Issue No. 08-8, "Accounting for an Instrument (or an Embedded Feature) With a Settlement Amount That Is Based on the Stock of an Entity's Consolidated Subsidiary"

EITF Issue No. 07-5, "Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock"

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"

EITF Issue No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments"

EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock"

EITF Issues No. 98-5, "Accounting for Convertible Securities With Beneficial Conversion Features or Contingently Adjustable Conversion Ratios"

EITF Topic D-98, "Classification and Measurement of Redeemable Securities"

AICPA Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*

Proposed SEC Regulation S-X, Article 13, "Use of International Financial Reporting Standards"

SEC Regulation S-X, Rule 4-08, "General Notes to Financial Statements"

SEC Regulation S-X, Rule 3-14, "Special Instructions for Real Estate Operations to Be Acquired"

SEC Regulation S-X, Rule 3-09, "Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons"

SEC Regulation S-X, Rule 3-05, "Financial Statements of Businesses Acquired or to Be Acquired"

SEC Regulation S-X, Rule 1-02, "Definition of Terms Used in Regulation S-X"

SEC Regulation S-K, Item 303, "Management's Discussion and Analysis of Financial Condition and Results of Operations"

SEC Staff Accounting Bulletin No. 108, codified as SAB Topic 1.N "Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements"

SEC Staff Accounting Bulletin No. 99, codified as SAB Topic 1.M, "Materiality"

SEC Staff Accounting Bulletin Topic 5.J, "Push Down Basis of Accounting Required In Certain Limited Circumstances"

PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements*

PCAOB Staff Audit Practice Alert No. 3, *Audit Considerations in the Current Economic Environment*

PCAOB Staff Audit Practice Alert No. 2, *Matters Relating to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists*

PCAOB AU Section 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"

IFRS 7, *Financial Instruments: Disclosures*

IFRS 3, *Business Combinations*

IAS 39, *Financial Instruments: Recognition and Measurement*

Appendix B: Topical Index

Click a topic to jump to a summary.

ACCOUNTING MATTERS

FASB Codification Project ... 18
Contingencies Acquired in a Business Combination (Proposed FSP FAS 141(R)-a) ... 17
Classification of Securities Issued under TARP ... 18
Classification of Securities with Redemption Features (EITF Topic D-98) ... 21
Distributions to Equity Method Investors ... 15
Events and Circumstances Triggering Goodwill Impairment Testing ... 12
Financial Instruments (FSP APB 14-1 and Issue 07-5) ... 19
New FASB Projects ... 16
Goodwill Impairment and Reconciliation of Market Capitalization ... 11
Impairment of Long-Lived Assets Held for Sale ... 9
Other Than Temporary Impairment: Standard Setting Activities ... 16
Other Than Temporary Impairment: Use of Judgment ... 18
Pensions ... 18
Push Down of Debt Under SAB Topic 5.J ... 12
Related Party Considerations in Applying Interpretation 46(R) ... 15
Repatriation of Foreign Earnings ... 14
Share-Based Payment Awards – Measurement of Liability-Classified Award ... 9
Statement 140 and Interpretation 46(R) Revisions (FSP FAS 140-4 and FIN 46(R)-8) ... 16
Statement 160 (Noncontrolling Interest) Implementation Issues ... 17
Statement 161 (Derivative Disclosures) Implementation Issues ... 21
Substantive Kick Out Rights (EITF Issue 04-5 and Interpretation 46(R)) ... 15
Fair Value in Inactive Markets ... 17
Valuation Allowances ... 14
Valuing Contingent Consideration ... 22
Valuing Intangible Assets Acquired in a Business Combination ... 22

BUSINESS COMBINATIONS AND NONCONTROLLING INTERESTS

Contingencies Acquired in a Business Combination (Proposed FSP 141(R)-a) ... 17
Push Down of Debt Under SAB Topic 5.J ... 12
Statement 160 (Noncontrolling Interest) Implementation Issues ... 17
Valuing Contingent Consideration ... 22
Valuing Intangible Assets Acquired in a Business Combination ... 22

CREDIT CRISIS
Effect of the Credit Crisis on the IASB's Agenda 23
Impact of Current Economic Environment on Internal Control 43
Lessons Learned 2
Other Issues Stemming from the Credit Crisis....4
Role of Fair Value in the Credit Crisis....3
Role of the Divisions of Corporation Finance in the Market Crisis 24
Study on Mark to Market Accounting 3

COMMITTEE ON IMPROVEMENTS TO FINANCIAL REPORTING (CIFiR)
Recommendations in the Final CIFiR Report to the SEC 35
Professional Judgment 11
Restatements....35

DISCLOSURES
Goodwill Impairment Disclosures 13
Management Discussion and Analysis 36
Management Discussion and Analysis of Fair Value: Best Practices 30
Management Discussion and Analysis of Liquidity and Capital Resources 28
Management Discussion and Analysis of Valuation Allowances 14
Section 404 Compliance Issues and Internal Control Disclosures 41
Statement 140 and Interpretation 46(R) Revisions (FSP FAS 140-4 and FIN 46(R)-8) 16
Statement 161 (Derivative Disclosures) Implementation Issues....21

DIVISION OF CORPORATION FINANCE
Division of Corporation Finance: Communications and Transparency....26
Division of Corporation Finance Rulemaking 25
Division of Corporation Finance: Working with the Public 25
Division of Corporation Finance Filing Review Process 27
Division of Corporation Finance Filing Review Statistics 28
Division of Corporation Finance's Role in the Market Crisis....24

FAIR VALUE
Fair Value Measurements....10
Best Practices for Fair Value Disclosures in Management Discussion and Analysis....30
FASB Standard Setting Related to Fair Value in Inactive Markets....17
Role of Fair Value in the Credit Crisis....3
Study on Mark to Market Accounting....3
Valuing Contingent Consideration 22
Valuing Intangible Assets Acquired in a Business Combination 22

FINANCIAL INSTRUMENTS
Financial Instruments (FSP APB 14-1 and Issue 07-5) 19
Other Than Temporary Impairment: Standard Setting Activities 16
Other Than Temporary Impairment: Use of Judgment 18
Statement 161 (Derivative Disclosures) Implementation Issues 21

FOREIGN PRIVATE ISSUERS
Foreign Private Issuer Rulemaking 37
Foreign Private Issuer Statistics 37
IOSCO Initiatives 39

FRAUD
Study on Fraudulent Financial Reporting 40

IMPAIRMENT
Events and Circumstances Triggering Goodwill Impairment Testing 12
Disclosures Related to Goodwill Impairment 13
Goodwill Impairment and Reconciliation of Market Capitalization 11
Impairment of Long-Lived Assets Held for Sale 9
Other Than Temporary Impairment 18

INCOME TAXES
Valuation Allowances 14
Repatriation of Foreign Earnings 14

INDEPENDENCE
Importance of an Independent Standard Setting Body 2

INTERNAL CONTROL OVER FINANCIAL REPORTING
Impact of Current Economic Environment on Internal Control 43
Section 404 Compliance Issues and Internal Control Disclosures 41
Section 404 Implementation Cost/Benefit Study 42

INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRSs)
Convergence 23
Effect of the Credit Crisis on the IASB’s Agenda 23
IASB’s Agenda 23
Proposed IFRS Roadmap 39

MATERIALITY
SABs 99 and 108 34

OTHER THAN TEMPORARY IMPAIRMENT
Other Than Temporary Impairment: Standard Setting Activities 16

Other Than Temporary Impairment: Use of Judgment 18

PCAOB

Calls for Regulatory Changes 2
Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury 5
Impact of Current Economic Environment on Internal Control 43
Section 404 Compliance Issues and Internal Control Disclosures 41
Section 404 Implementation Cost/Benefit Study 42
Oversight of the PCAOB 44
PCAOB Risk Assessment Standards 44
PCAOB Standard Setting Activities 46

SEC MATTERS

Division of Corporation Finance: Communications and Transparency 26
Division of Corporation Finance Rulemaking 25
Division of Corporation Finance: Working with the Public 25
Division of Corporation Finance Filing Review Process 27
Division of Corporation Finance Filing Review Statistics 28
Division of Corporation Finance's Role in the Market Crisis 24
Foreign Private Issuer Rulemaking 37
IOSCO Initiatives 39
Management Discussion and Analysis 36
Management Discussion and Analysis of Fair Value: Best Practices 30
Management Discussion and Analysis of Liquidity and Capital Resources 28
Management Discussion and Analysis of Valuation Allowances 14
Professional Judgment 11
Recommendation in the Final CIFiR Report to the SEC 35

STANDARD SETTING

FASB Codification Project 18
FASB Initiatives 16
IASB's Agenda 23
PCAOB Standard Setting Activities 44

SHARE BASED PAYMENT AWARDS

Measurement of Liability-Classified Share-Based Payment Awards 9

VARIABLE INTEREST ENTITIES

Substantive Kick-Out Rights 15
Related-Party Considerations in Applying Interpretation 46(R) 15

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