

# Accounting, Auditing and Regulatory Developments

May 4, 2010

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# Accounting, Auditing and Regulatory Developments



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Important Trends Affecting Current Financial Reporting

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SEC Comment Letters on Current Credit Environment Disclosures

- SEC comment letters focusing on the adequacy of disclosures about:
  - Liquidity positions
  - Debt covenants
  - Investments
  - Impairment valuations
  - Income taxes
  - Subprime residential mortgage exposures
  - Pension and defined benefit plans

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Recent Developments – Effective Now

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Uncertainty in Income Taxes – Taxing Authority Latest to Weigh In

- New model for recognizing and measuring uncertain tax positions, effective 2007 for public companies
- Nonpublic companies required to adopt for annual periods beginning after December 15, 2008
- Benefit recognized only if “more likely than not” that tax position will be sustained
- The IRS proposed that certain companies would be required to disclose information about uncertain tax positions as part of their federal tax returns
- Could lead to:
  - Greater earnings volatility
  - Increased scrutiny from tax authorities
  - Diminished aggressive tax positions

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Accounting hot topics - Uncertain tax positions - The IRS says “show me”

- IRS has proposed new tax requirements for companies with more than \$10 million of assets to disclose
  - Uncertain tax positions as part of their federal tax return
  - Reason for the uncertainty, and
  - Maximum amount of tax liability that would result if the position was not sustained
- Proposal would not require management to provide assessment of the position or the amount of the “booked” reserves
- Proposed effective date would potentially include 2009 calendar year filings, it is believed the IRS will postpone that date to 2010

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### Accounting hot topics Effective tax rate reminders

- Few important reminders for companies as they estimate their effective tax rate (ETR) for upcoming year:
  - Exercise care when determining whether an item is unusual or infrequent
  - Assess whether changes in management's indefinite reinvestment assertions impact the ETR
  - Determine whether the tax expense or benefit is required to be recognized in the current period

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### Accounting hot topics Taxing matters - Certain benefits expire...for now

- Several notable US tax provisions expired on December 31, 2009 (i.e. research credit, controlled foreign corporation (CFC) "look-thru" rule, etc)
- Congress may consider retroactively extending the expired provisions, however the timing is uncertain
- Companies should consider the impact of the expired provisions on their deferred taxes and as they estimate their annual effective tax rate for 2010

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### Non-GAAP Financial Measures

- The SEC noted that companies provide non-GAAP information on websites and analyst calls without including it in their SEC filings
- The SEC is concerned that the "official" disclosure documents (e.g., Form 10-Ks and 10-Qs) may be less useful if the non-GAAP information is not included in those documents
- The SEC clarified their existing rules on non-GAAP to improve consistency
- Companies should continue to be cognizant of the prohibitions contained in the existing rules
- Companies should expect that the SEC will focus on the consistency of all company communications

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### Codification

- Codification is the single official source of authoritative, nongovernmental, US generally accepted accounting principles (GAAP).
  - Changes how companies reference US GAAP in financial statements
  - Effective for interim and annual periods ending on or after September 15, 2009
- Companies encouraged to use plain-English, to change references in disclosures for comparative periods

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### XBRL

- XBRL is a computer-readable language for the electronic communication of business information
- SEC proposed a rule for requiring filings in XBRL format over a three year period
  - Effective June 15, 2009 for the largest companies
  - Phased-in for other companies June 15, 2010 or June 15, 2011

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### Internal Control Audit Requirements for Many Smaller Companies

- SEC gave non-accelerated filers (generally with public float below \$75 million) a six-month extension to comply with internal control over financial reporting audit requirements.
  - No impact on internal control transition schedule for newly-public companies
  - Management reporting requirements have not been deferred
- Companies are required to comply with the audit requirements beginning with annual reports for fiscal years ending on or after June 15, 2010.

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### Disclosures about Pension and Other Postretirement Benefit Plan Assets

- New annual disclosures include :
  - How companies make investment allocation decisions
  - Major categories of plan assets
  - Significant concentrations of risk
  - The level within the fair value (FV) hierarchy in which the FV measurements fall
  - Information about inputs and valuation techniques
  - A roll forward of plan assets that were valued using significant unobservable inputs
- Effective for years ending after December 15, 2009

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### Developments Nearing Completion

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### Loss Contingencies

- In 2008 the FASB proposed extensive new disclosures for loss contingencies
- In response to concerns the FASB tentatively decided:
  - Disclosures should focus on publically available information
  - Companies should not have to make disclosures that would prejudice the outcome of the contingency
- New standard expected in 2010
- IASB proposed a new standard for recognition and measurement of loss contingencies that could influence the FASB
- The IASB proposal included:
  - Companies will recognize at a less than "more likely than not" threshold
  - Liabilities would be measured at the present value of the amount that a company would "rationally pay"
- The IASB proposal could influence certain elements of the FASB/IASB joint projects on revenue recognition and insurance

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### Going Concern

- In October 2008, the FASB issued an exposure draft to incorporate going concern guidance into the accounting literature. Based on comments received they are revisiting the topic.
- The revised proposal is expected to :
  - Define thresholds for management's assessment of the risk that a company is not able to continue as a going concern, using new terms
  - Direct management to consider available information about the foreseeable future (i.e., not limited to 12 months)
  - Evaluate the significance of risks and uncertainties on an absolute and residual level
  - Require additional disclosure
- FASB is expected to issue a new exposure draft in the 2<sup>nd</sup> quarter of 2010 and a final standard in the 3<sup>rd</sup> quarter of 2010.
- Effective date is likely to be 2010 for calendar year-end companies.

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### Evolving Developments

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### Movement to IFRS

- In February 2010, the SEC confirmed its continued support for a single set of high-quality global accounting standards
- The SEC will now carry out a Work Plan to assist it in considering whether or how to incorporate IFRS into the financial reporting system for US public companies.
- The SEC plans to make a determination on IFRS by 2011.

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### Auditing Standard No. 7, Engagement Quality Review

Effective for first quarter interim reviews for calendar year-end audit engagements

- Reviewer to evaluate
  - Significant judgments
  - Conclusions reached
- Partner or person of equivalent position
- Provide concurrence when satisfied is not aware of significant deficiency
- Documentation
  - Appropriate team response
  - Supports conclusions reached

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### Financial Statement Presentation

- The FASB and IASB proposed primary financial statements would consist of a balance sheet, cash flow statement and statement of comprehensive income (combines income statement and other comprehensive income items)
- At the end of 2009, the following key tentative decisions were made:
  - Require the direct method of cash flows
  - Require an indirect reconciliation of operating cash flows in footnotes
  - Eliminate line by line reconciliation
  - Require disaggregation principle
- An exposure draft is expected to be released in 2010
- Could affect key company metrics

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### Leases

- Under the FASB and IASB proposed model:
  - Off-balance sheet accounting eliminated
  - All lessees would apply a "right-of-use" model
  - Performance measures will change as rent expense will be replaced by interest and depreciation expenses
  - Minimal grandfathering of existing leases
- The following key tentative decisions were made regarding lessor accounting:
  - Performance obligation model - new right created
    - Asset remains on balance sheet
    - Separate receivable and performance obligation recognized
  - Lease term - should be estimated at the beginning of the lease when the term of the lease or required payments are not fixed and should be reassessed throughout the lease term
- Exposure draft is expected in 2010

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### Employers' Accounting for Pension/Post-Retirement Benefits under IFRS

- The IASB reconsidering accounting for pension and other postretirement benefits
- In early 2009, it tentatively decided companies should:
  - Recognize all changes in plan assets and benefit obligation in the period incurred
  - Classify benefit costs into employment, financing or remeasurement elements
  - Actuarial gains and losses on the obligation and actual return on plan assets would be included in the remeasurement element
- The IASB has tentatively decided that there will be a single continuous statement of comprehensive income
  - There will be subtotals for net income and other comprehensive income (OCI)
  - Remeasurement costs will be included in OCI
- The IASB is expected to issue an exposure draft in the second quarter of 2010.

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### Accounting hot topics - Contingent consideration—“Earnouts” could be earnings surprise

- Contingent consideration in an M&A transaction
  - These payments are commonly referred to “earnouts” and are typically based on revenue or earnings targets
  - The accounting for these arrangements has changed significantly since the issuance of FAS 141 (R) (codified in Topic 805)
- Companies should read PwC’s *Mergers & Acquisitions – A snapshot: Accounting for contingent consideration for further information*

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### Sustainability and Climate Change

- Lowering greenhouse gas (GHG) has become a focal point for many large organizations
- The Environmental Protection Agency has taken initial steps to regulate GHG emissions
- Large emitters of GHG:
  - Will need to measure output starting in 2010
  - Will need to prove they are using the best technologies when upgrading or building new facilities
- US government has devoted money to increasing companies’ energy efficiency and developing GHG-reducing technologies
- US government agencies asked to reduce their energy usage and report their environmental impact and US government vendors and contractors will be asked to do the same
- The SEC released interpretive guidance for companies to use when disclosing material risks that could warrant disclosure related to climate change in their regulatory filings

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### Trends in SEC Reporting

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### Revenue Recognition

- SEC comment letter themes include:
  - Inconsistencies between MD&A and revenue policy disclosures
  - Gross versus net presentation of revenues and related expenses
  - Further revenue recognition disclosures on units of accounting and arrangements
  - Discussion of key revenue variables to enable understanding and evaluating results
  - Identification of pricing rates as driver of profitability and impact of pricing changes on profitability

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### Segment Reporting

- SEC comment letters focus on whether segments are properly identified:
  - Inconsistencies with website, articles, publications, press releases, filings, reporting package, goodwill assessment
  - If assert that only one segment exists
  - The interaction between goodwill and segment reporting
  - Criteria used for aggregating segments that have similar economic characteristics

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### Other Recurring SEC Comment Letters (1)

- Executive Compensation:
  - Disclose how and why arrived at compensation decision and policies
  - Present information in useful and meaningful manner
  - Add clarity on the difficulty of achieving performance goals
  - Add specificity around incentive plan performance targets
  - Provide discussion of all material compensation arrangements
  - Name companies included in benchmark analysis
  - Define roles and responsibilities

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### Other Recurring SEC Comment Letters (2)

- MD&A- General
  - An executive overview reviewing the period's business activities
  - An in-depth analysis of operating cash flows and changes in working capital.
  - A quantification and robust explanation of significant financial statement line item variances versus comparative periods
  - A summary of trends and expected future events that could affect a company's results

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### Other Recurring SEC Comment Letters (3)

- MD&A—R&D:
  - Timing for commercialization of R&D projects
  - If company doesn't track costs by project, other disclosures expected to explain resources allocated to projects
  - Range of estimates for costs and estimated completion dates

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### Other Recurring SEC Comment Letters (4)

- Non-GAAP Measures:
  - Relevance of non-GAAP measure
  - Whether a measure of performance or liquidity
  - Reconciliation to net income or operating cash flows
- Income Taxes
  - Factors considered in adjusting valuation allowances
  - Describe the "other" line item included in the tax rate reconciliation
  - Enhance disclosures related to uncertain tax positions

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### Other Recurring SEC Comment Letters (5)

- Restructurings and Impairments:
  - Impact of restructuring on liquidity
  - Basis for adjustments and support for initial accounting
  - Support for timing of charges
- Impairments
  - Support for and disclosing valuation techniques and assumption
  - The amount of goodwill allocated to each reporting unit
  - Degree of uncertainty related to key assumption
- Business Combinations and Intangible Assets:
  - Support for classification, useful lives and amortization method for intangible assets
  - The factors that resulted in the recognition of goodwill
  - Explanation of purchase price allocation and impact of amendment
  - Identification of appraiser and their consent

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