

2008 Current developments for directors*

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To our clients and friends:

We recognize that the pressure on directors persists. In recent years, you have devoted time and effort to coping with the implications of emerging rules, and while those developments continue to pose some challenges, for the most part your boards are handling them. But fresh challenges have arisen—not from regulation, but from a major shift in economic conditions. Directors need to focus on how their companies are reacting to this changing economic environment and, in particular, on how management is responding. It's clear that directors will need to remain engaged as conditions evolve, bearing in mind that circumstances may shift in ways that are unpredictable and even sudden.

Another environmental factor is the changing relationship of the US capital market with its counterparts in the global marketplace. The growing sophistication and depth of markets outside the United States is providing companies with greater choice when raising capital. Consequently, that is sharpening the focus on factors affecting US market appeal—particularly the effect of the regulatory and legal systems. Recognizing that the complexity of financial reporting may also impact US capital market competitiveness, the SEC established a committee to look at ways to improve financial reporting. We anticipate that some of the committee's recommendations—which are expected in late summer 2008 and are intended to result in more efficient and effective financial reporting—could affect companies as early as their 2008 year-end.

The broader global perspective in today's capital markets is reflected in recent activity in the standard-setting and regulatory arenas. The FASB and its international counterpart, the IASB, jointly issued the first set of converged accounting standards (on business combinations), and the SEC has taken the unprecedented step of allowing non-US companies to file their financial statements under International Financial Reporting Standards (IFRS) without reconciling them to US GAAP. This is part of a process that we at PricewaterhouseCoopers believe is inevitable—US companies will eventually report from a platform of high-quality global standards, built on IFRS. We are seeing some US multinational companies—which believe adopting IFRS will prove advantageous—already prepare for this eventuality.

On other fronts, shareholders continue to show a high level of interest in executive compensation decisions and the director-nomination process—both are areas where the SEC also has had important input.

This is sizing up to be a demanding year. PricewaterhouseCoopers is committed to helping you understand the issues and work through them. We would be pleased to discuss the contents of this publication and, in whatever ways are helpful, to deliver to you and your board colleagues the full resources and experience of our firm.



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Table of contents

Implications of the changing credit markets	1
The credit environment	2
Impact on valuations	3
Other considerations	5
Dealing with complexity and US competitiveness	8
IFRS on the horizon	9
US competitiveness	11
Complexity	12
Spotlight stays on executive compensation	15
Revisiting executive compensation disclosures	16
Empowering shareholders in compensation decisions	18
Using compensation consultants	19
Continued push for shareholder empowerment	20
Proxy access	21
Expanding the use of technology	22
Financial reporting developments	24
Accounting for mergers and acquisitions	25
Fair value measurement	27
Uncertain tax positions— an update	28
SEC developments	31
Changing faces	32
Areas of focus	32
Progress on XBRL	33
Developments impacting auditing	34
Treasury committee on auditing	35
Changing auditor independence rules	36
Section 404 update	37
Other noteworthy developments	38
The Aspen Principles	39
Postretirement benefits, including pensions	40
Appendix A—Developments affecting smaller companies	41
Appendix B—Developments affecting non-US companies	44
Appendix C—<i>What Directors Think</i>—2007 survey	48

Implications of the changing credit markets

Events in late summer 2007 triggered significant volatility in the global financial markets, with seasoned executives describing bond market conditions as among the worst seen in their careers. Credit markets worsened during the fall. At some financial institutions, write-downs reached \$10 billion and beyond. Boards replaced senior executives at major financial institutions, and some of those institutions had to seek additional capital infusions offshore. Companies now realize that this is not just a sub-prime mortgage problem. Nonfinancial companies are also facing challenges in valuing fixed-income investments, are in some cases writing down their investments (as well as assets in employee benefit plans), and are seeing some tightening of credit availability.

The credit environment

Attention to the state of the current credit markets was driven initially by the US sub-prime mortgage market. As housing prices softened and loan rates on adjustable rate mortgages began to reset higher, borrowers weren't always able to refinance or sell their homes for more than the loan amount, and so defaults rose.

The credit issues did not stop with the sub-prime mortgage market in the United States. They spread to other markets and financial products that were not expressly tied to sub-prime borrowers. Credit spreads—essentially the difference between the yield on corporate bonds and the yield on similar US government bonds—widened. Trading volumes in various securities decreased significantly, and illiquidity in a number of markets became a major concern. Bidders were offering low prices, which prospective sellers believed were far below the fair value of the debt securities. As a result, it became difficult to obtain price quotes for numerous securities.

In the third quarter of 2007, some financial institutions reported significant losses due to the credit crunch. Many of the same companies announced additional write-downs for the fourth quarter. These losses—driven by fundamental declines in the market—have affected both financial and nonfinancial companies, cutting across a broad spectrum of industries that invested in fixed-income products, including the manufacturing and technology industries. Endowment funds, pension funds, and other employee benefit plans have been affected as well.

Impact on valuations

The current credit environment and the behavior of the capital markets is challenging companies as they struggle to determine the fair value of certain investments.

The accounting literature does not permit companies to take a “normalized” or “longer term” view when considering the fair value of an investment. It requires that current market prices be taken into account—even if the view is that those prices are too low—in preparing the financial statements for the current period. This is true even if the prices reflect a temporary market anomaly and there’s an expectation that the credit markets will eventually recover.

Determining fair value—an overview of practice in the present environment

For accounting purposes, fair value is broadly defined as the price received to sell an asset (or paid to transfer a liability) in an orderly transaction between market participants. Because of market uncertainty and illiquidity, valuing investments in the current environment may be challenging depending on a number of factors, including a company’s ability to obtain prices or information about those prices. Acceptable methods for obtaining valuation information to estimate fair value include (in descending order of preference)

- Quoted market prices for identical instruments: These generally are the best indicator and should be used, if available and not out of date.
- Quoted market prices for similar instruments: If a company uses prices for similar instruments, it should expect to adjust those prices to account for differences between the similar investments and the investment it actually holds.
- Valuation techniques that use inputs observed in the marketplace—such as yield curves, market indices, default ratios, and discounted cash flows: Illiquidity and the lack of trading volume that companies have been facing make this type of analysis difficult or less reliable, driving many to resort to the method below.
- Valuation techniques using inputs not observable in the marketplace—for example, information based on the company’s own internal data: These techniques are particularly challenging, requiring management to extrapolate from its internal data and related marketplace data. Given that many of these valuation models and estimates have been internally developed and are proprietary, they also typically haven’t had the benefit of market scrutiny.

The sudden absence of readily available quoted market prices makes it more difficult for companies to value investments—especially if they also lack the in-house expertise to create and evaluate valuation models. Even companies with valuation expertise are facing challenges as they create new models or adapt current models to estimate the fair values of illiquid investments. For some companies, the sheer volume of instruments they hold, coupled with the current environment, is making valuations especially time-consuming. In all instances, companies should carefully evaluate the assumptions they use in their valuation models to ensure that they reflect the current market environment and not a “normalized” or historical environment that is no longer relevant.

Certain other companies that used investment advisors have discovered that the value of their investment portfolio has declined substantially, depending on the products they had invested in. For instance, some companies have had to record write-downs relating to auction rate securities. These securities have interest rates set by an auction process. If the auction fails (which it does when there are insufficient orders to purchase the securities), the interest rate is set at the maximum rate allowed per the offering documents, and this increase in the interest rate can cause the fair value of the security in question to decline if the maximum rate happens to be below prevailing market rates. In late 2007, the auction process failed in numerous instances and consequently led to such write-downs.

Valuations could become especially challenging for companies valuing assets in pension and other employee benefit plans. Why? Because such plans tend to invest a significant proportion of their funds in fixed-income products and they sought higher returns for such investments. And, given that companies now present on their balance sheets any unfunded liability in such deferred benefit plans, declining values in pension fund assets potentially will increase liabilities that are reported on balance sheets, or potentially will reduce assets.

Alternative investments

Similar to other investors, some companies are investing in nontraditional asset classes—such as private equity and hedge funds—to diversify risk and increase returns. But such funds typically provide investors with little information on their underlying investment portfolios, largely because investment managers want to protect proprietary information about their investment strategies.

That means it can be difficult for those investors to monitor and get comfortable with the valuations of these alternative investments. It's important for investors to have a sufficient understanding of the nature of the underlying investments, the portfolio strategy, and the methods and significant assumptions the fund managers use to value those investments. Investors should take the steps needed to obtain the requisite information. Those may include

- Having periodic discussions with the investment managers, and possibly making site visits in the case of significant investments
- Analyzing investment performance (e.g., comparing such performance to expected benchmarks and investigating unexpected volatility and/or results)
- Continuing to review periodic statements that reflect the investment manager's investment decisions and comparing those decisions with the investor's records

Directors also will want to understand the nature and extent of the company's alternative investments and the relative complexity entailed in valuing them.

Other considerations

As mentioned earlier, the credit environment's impact extends well beyond financial institutions—few sectors are free from potential exposure. For example, credit risk profiles are increasingly deteriorating for companies in the building products and construction industries; companies that have exposure to mortgage originators and bond insurers; and companies investing in mortgages or mortgage-backed securities. Companies also may find they are at risk of not complying with guarantee arrangements and debt covenants because ratings on their investments have been downgraded. In this credit environment, if a company is having difficulty refinancing or otherwise meeting its current debt obligations, that may in turn call into question its viability as a going concern.

Implications of commercial paper structures

The credit environment turmoil has put the spotlight on structures financed by commercial paper. Structured investment vehicles (SIVs) are one such type of commercial paper conduit. SIVs issue short-term commercial paper to investors, and then use the proceeds to purchase higher-yielding longer-term fixed-income assets—often including mortgage-backed securities. Many of those assets declined substantially in value as the market repriced credit risk. With the declining values of underlying assets, rating agencies have been considering the ratings of commercial paper issued by SIVs. That in turn has lessened demand for that commercial paper.

If SIVs cannot reissue commercial paper once it becomes due, they may need to sell the underlying assets—potentially at fire sale prices—thereby creating additional downward pricing pressure. To avoid having to sell underlying assets, some sponsors of commercial paper conduits (which often are financial institutions) have provided these conduits with additional financial or other support—for instance, by providing guarantees and liquidity facilities, or by buying conduit assets at prices above fair market value.

Providing such support to a conduit has accounting implications. US accounting standards require conduit assets and liabilities to be reported on the balance sheet if the company may be responsible for the majority of the risk. If a sponsor provides funding or support to a conduit that it did not anticipate at the time the conduit was established, it may need to reevaluate whether it should consolidate the conduit.

The SEC also is focusing on companies' disclosures about credit exposures, particularly sub-prime residential mortgage exposure. It has asked for additional disclosure about a number of topics relating to the credit environment, including current write-offs or impairments, the timing of those losses, and future trends and uncertainties that may impact earnings, liquidity, or capital resources. This focus isn't restricted to financial services companies. All companies should consider whether they need to enhance disclosures relating to risk factors and liquidity in Management's Discussion and Analysis.

The credit situation has been challenging and remains fluid. In communicating to shareholders, companies should articulate the difference between any write-downs recorded for market events and those based on judgments management has made on accounting and valuation measurements. This will allow investors to better anticipate the impact of any future deterioration of the credit market or economic conditions, which may require further write-downs in asset values.

Directors' actions

- Understand management's process for identifying exposures to the sub-prime market and discuss whether all exposures have been flagged. Focus on investments in asset-backed securities and funds with significant concentrations in fixed-income investments (e.g., collateralized debt obligation funds, mortgage funds, money market funds, auction rate securities, enhanced or structured debt funds, high yield funds).
- Discuss with management how it determines the fair value of its investment portfolio. Are there active markets to provide quoted prices? Does the company use pricing services or broker quotes? To what extent does it use model-based valuation techniques? Pay particular attention to changes in pricing methods—for example, a move from a quoted market price to a valuation model. Ask management about the reasons for the change. Also understand how the company validates fair value. For example, does it source other external market data and perform both a transaction analysis and a portfolio analysis to assess the overall appropriateness of the valuation?
- Ask management about significant assumptions and other inputs it uses in its valuation model, how those assumptions were evaluated and validated, and whether they reflect current market conditions. Focus on areas where management has not previously used valuation models but has since had to incorporate them because quoted market prices may not be available.
- Determine whether the current credit events have impacted or could impact the company's ability to refinance, service debt obligations, meet debt/contractual covenants, or alter guarantee arrangements. Discuss the impact on business strategies and perhaps even the company's ability to continue as a going concern.
- Assess the company's risk management practices, how risk is measured, whether appropriate risk tolerances and approvals are in place, and how they are monitored. For example, companies may use "value at risk" (VAR) models to measure and assess risk. Typically, companies that use VAR models will set limits or caps that are monitored by management. Inquire how the increased market volatility has affected the risk measures used and whether adjustments may be appropriate.

Dealing with complexity and US competitiveness

The competitiveness of US capital markets and the impact of the complexity of US accounting and reporting were key concerns in 2007. We expect these issues to remain a priority over the next few years. One significant development involves the arrival of International Financial Reporting Standards (IFRS) in the United States.

IFRS on the horizon

Recognizing the financial reporting revolution that is occurring outside the United States—where more than 12,000 public companies in over 100 countries are or will be using IFRS—the SEC has taken significant steps toward bringing IFRS to the United States.

- Non-US companies that prepare their financial statements under IFRS (as issued by the International Accounting Standards Board (IASB))¹ no longer have to reconcile those statements to US GAAP.

This is significant. It signals that the SEC believes IFRS ultimately will be of sufficient quality and transparency to be used for financial reporting in the United States. And, the SEC's recognition and support of the version of IFRS published by the IASB should help stem the proliferation of territorial variations of IFRS around the world. Further, the SEC's removal of the reconciliation requirement eliminates a costly burden for non-US companies and therefore makes the US capital markets more attractive. Two forms of GAAP are now accepted in the United States—a groundbreaking step for US financial reporting.

- The SEC is studying whether US companies should use IFRS.

The SEC is evaluating the implications for the market, and the preferred timing and approach to such a transition. Full adoption of IFRS in the United States would mean eliminating US GAAP as the financial reporting language.

For many in the United States, the SEC's recent steps toward convergence are a wakeup call, spurring the realization that US financial reporting, in its current state, is likely to change in the coming years.

The first major accounting standards developed in a joint process between the FASB and the IASB are the new standards on business combinations.² This effort demonstrates that although the two standard setters might not always agree on technical conclusions, their commitment to principles and teamwork allows them to create converged—though not identical—standards.

The FASB and the IASB will continue their joint standard-setting activities. Their current agenda is designed, in part, to ensure that IFRS will meet the needs of a global investor community. The agenda includes revenue recognition; classification of liabilities and equity; financial statement presentation; and leasing. US companies will want to track these as well as other developments—both at the IASB and the FASB—to ensure that they have the opportunity to weigh in on the emerging accounting standards they will use to report results in the future.

1. See further discussion in “Developments affecting non-US companies.”

2. See further discussion in “Financial reporting developments.”

At PricewaterhouseCoopers, we believe it is inevitable that US companies will have to report using IFRS, as a step toward achieving a common global financial reporting language across all companies in all jurisdictions. In our view, setting a mandatory date for all US public companies to adopt IFRS and allowing earlier adoption is the best approach, as it will motivate the multiple stakeholders to address the challenges associated with a move to IFRS. We also believe a detailed roadmap should be developed to facilitate addressing important transition issues in this process. But we recognize that gaining consensus in the immediate future around a mandatory date to transition to IFRS may be challenging. And so, we hope that any plan for transitioning US companies to IFRS will at a minimum allow near-term adoption, so that multinational companies can implement IFRS sooner, making them more competitive in the global marketplace. Their experience also will help other companies prepare for the change.

Because we believe the transition to IFRS is inevitable, we urge directors to understand what switching to IFRS might mean for their company, industry, and investors.

Advantages to adopting IFRS in the United States

- Increases global comparability of companies' results
- Enhances the efficient allocation of capital
- Improves US market competitiveness, given that IFRS is commonly accepted and understood in the global capital markets
- Simplifies the application of accounting standards, since IFRS has fewer rules and exceptions than US GAAP
- Allows broader use of professional judgment
- Allows multinational companies to improve reporting processes and reduce costs by
 - Centralizing global accounting and financial reporting functions
 - Easing ability to move personnel among countries

IFRS requires both management and auditors to use considerable judgment in the financial reporting process. The concern is that the current litigious US environment makes applying judgment risky—one factor behind the push in the United States for a rules-based approach to financial reporting.

US competitiveness

The growth of effective and efficient capital markets outside the United States is providing companies with more alternatives for raising capital. There is concern that this competition is causing the United States to lose market share. Many factors—including the complexity of US accounting standards, and the litigious legal environment—have been cited as increasing the cost of raising capital in the United States. Meanwhile, markets in Europe and Asia are providing companies with viable alternatives—increasingly efficient market systems with capital available at an attractive price.

On top of that, mergers between US and European exchanges are creating global exchanges that provide other attractive capital-raising opportunities. Not only are companies choosing not to register in the United States in the first place, non-US companies are also increasingly opting to leave the US securities market. Over 100 non-US companies deregistered from the United States between June and December 2007. The growth of private equity and 144A financing—private placement deals available only to qualified investors—are two other trends keeping companies out of the traditional SEC registration process that culminates in an IPO. Further, unregulated secondary capital markets (such as the Open Platform for Unregistered Securities—Opus-5, and the Goldman Sachs Tradable Unregistered Equity system—GSTRUE) are emerging that allow investors to trade 144A securities.

Understandably, this shift away from US capital markets is attracting attention. Over the past few years, various reports have been issued, including those from a committee convened by the US Treasury Secretary, a commission established by the US Chamber of Commerce, and senior New York politicians. The recommendations in these reports run along common themes—support for convergence of IFRS and US GAAP and the need for litigation reform. Business leaders also have weighed in with views that the overly regulatory and highly litigious environment is putting US markets at a significant disadvantage.

It's clear to many that the United States needs to make important changes to remain competitive in the global capital markets. We support evaluating the impact that changes in the US legal and regulatory environment have on the cost of doing business and accessing capital in the United States.

Complexity

Complexity in reporting has emerged as a particular challenge. Responding to broad concern about complexity, the SEC formed the Advisory Committee on Improvements to Financial Reporting (CIFiR) in August 2007 to examine the US financial reporting system. Its primary objectives are to find ways of increasing the usefulness of financial reporting to investors and reducing unnecessary complexity. With a one-year charter and much to accomplish, CIFiR has established four subcommittees to study specific areas of concern:

- **Substantive complexity:** To examine what drives complexity in financial accounting and reporting standards, including (1) standards based on rules rather than principles; (2) exceptions, bright lines, and safe harbors; and (3) fair value measurement attributes and related earnings volatility
- **Standard setting:** To focus on complexity resulting from the US GAAP hierarchy, the standard-setting process, and interpretive and informal guidance
- **Audit process and compliance:** To explore the impact that regulators' processes have over financial reporting and auditing, second-guessing of judgments, causes for the increase in restatements, and the degree to which companies and auditors hesitate to exercise professional judgment in the absence of detailed rules
- **Delivering financial information:** To study how financial information is communicated to and accessed by investors and other users

In formulating its recommendations, each subcommittee will be considering the impact of the international environment.

Among CIFiR's preliminary recommendations:

- Develop a formal framework that will encourage greater use of professional judgment—a behavioral change that is especially needed as US companies move towards IFRS (principles-based standards)
- Enhance materiality standards to provide guidance on correcting and disclosing errors and on qualitative factors that should be used in determining whether an error is material
- Promote accounting standards that are more principles-based
- Eliminate industry-specific standards, bright lines, and detailed rules, thereby reducing the volume of accounting literature
- Use XBRL (eXtensible Business Reporting Language) as a more efficient way of delivering and accessing financial information and as a means of improving companies' internal financial reporting processes

CIFiR will work its recommendations through a public comment process during 2008. The hope is that the recommended changes will alleviate some of the compliance burden, enabling management to focus more on creating value and growing its business. If approved, the recommendations may require changes not only by companies, but also by regulators and auditors. More broadly, such changes also could help the US capital markets maintain their position in the increasingly competitive global economy.

Perspectives on financial reporting judgments

Companies and auditors are required to apply judgment today. Therefore both parties need an environment that supports their exercise of professional judgment, since this will be increasingly important as the United States transitions to more principles-based accounting standards. That said, some investors are uncomfortable with this notion, believing that it might provide an inappropriate level of protection to management and auditors for judgments that are not made in good faith.

PwC supports the disciplined application of judgment, to be used consistently by both companies and auditors. We also encourage enhanced disclosures by companies about the most critical estimates and judgments underlying their financial reporting—which we believe will be beneficial to investors.

Elements that are critical to a consistent application of judgment include

- Obtaining all the relevant facts
- Understanding the underlying economics of the transaction
- Evaluating alternative accounting treatments
- Documenting the thought process applied, at the time judgments are made
- Increasing the transparency of disclosures about judgments

We believe that these elements will improve the quality of financial reporting and audits. Incorporating them into the application of professional judgment should facilitate robust discussions with audit committees about how management evaluates alternatives and reaches judgments, and where on the continuum—from reasonable to unreasonable—those judgments fall. The improved disclosure will allow investors to better understand how the key judgments are made and how they evolve over time.

Regulators—including the SEC, the Public Company Accounting Oversight Board, and industry regulators—and the legal community have a central role in determining whether any of the recommendations to reduce complexity ultimately will prove successful. For example, given that different companies may reach different judgments for similar transactions, regulators' actions will impact how companies apply accounting standards. Policymakers and regulators should focus on creating a legal, regulatory, and enforcement environment that has greater tolerance for and recognition of the value of professional judgment.

CIFiR's focus on applying professional judgment in corporate reporting, redefining what constitutes materiality, and applying more principles-based accounting standards will be helpful in addressing complexity.

The complexity/materiality/restatement link

The relatively high level of complexity in financial reporting makes it challenging for companies to “get it right the first time.” If a company finds an error, it needs to determine whether the error is material,³ which will then govern whether it needs to restate its financial statements.

There was a significant increase in the number of restatements between 2002 and 2006. Although the level of restatements declined somewhat in 2007, it remains considerably higher than historic levels. But the fact that there has been little or no market reaction to many restatements suggests strongly that investors do not view all restatements equally. As a result, questions are being raised as to whether some of these restatements were unnecessary.

CIFiR and other parties are considering ways to address unnecessary restatements. One way is to rethink which errors are material. While materiality judgments typically have been skewed toward considering qualitative factors that render relatively small errors “material,” we support and are seeing an increasing acceptance of the notion that qualitative factors also can indicate that a relatively large accounting error may be immaterial from an investor’s perspective. This shift in thinking may become more significant as economic conditions weaken in the United States and companies face either lower earnings or earnings at break-even or loss levels.

These are challenging issues to address. Consider a company that had immaterial errors over a number of years. When it detected the errors, it found that correcting the cumulative error would be material to that year’s results. With the investor’s perspective in mind, should a company really be forced to restate for a number of years, for immaterial amounts, as is currently required?

It’s clear that the debate and scrutiny around materiality will continue. Stay tuned.

Directors’ action

If the SEC decides to let US companies report under IFRS, discuss with management the benefits and risks of any plans to transition to IFRS early. If management does intend to transition to IFRS, understand those plans and be satisfied that they cover

- Identifying and training IFRS resources at various levels in the company
- Examining opportunities to centralize accounting functions and embed IFRS into operations and existing systems
- Considering changes to contractual arrangements, such as software licenses, debt covenants, and executive compensation
- Establishing a strategy for communicating with investors

3. See “Evaluating financial statement errors” in *Current Developments for Directors 2007*, available at www.pwc.com/uscorporategovernance.

Spotlight stays on executive compensation

Executive compensation promises to remain a focal point in 2008. Shareholders are requesting more say in compensation packages and stronger linkages between pay and performance; the SEC is calling for improved disclosure; and companies are concerned about the level of transparency sought by the SEC. Shareholders increasingly are holding directors accountable for executive compensation policies and levels. Meanwhile, the media scrutiny of executive pay levels is unlikely to abate, particularly in light of current economic challenges.

Revisiting executive compensation disclosures

The SEC's revised disclosure rules on executive compensation took effect for the 2007 proxy season,⁴ providing investors with more comprehensive disclosures on all forms of executive compensation. The SEC reviewed these disclosures and issued comment letters to 350 companies. It also separately summarized the principal themes emerging from those reviews, stating its expectation for improved disclosures from all companies in 2008 and beyond.

The bottom line: In the SEC's view, there is considerable room for improvement in executive compensation disclosures.

The SEC issued more comments on performance targets than on any other area of executive compensation disclosures. If companies determine that corporate and/or individual performance targets are material to compensation decisions, they must disclose those targets. But a company may refrain from specifying performance targets if disclosing that information would put it at a competitive disadvantage. In lieu of disclosing performance targets, a company must specify in its filing how difficult it would be for the executive to hit the undisclosed targets or how likely it is that the company will meet those goals. The SEC found that many companies have fallen short of fulfilling this requirement, by either not disclosing targets or failing to convey the likelihood that the company or executive would meet the undisclosed targets.

We are seeing a mixed response to the SEC's request for increased disclosure around performance targets. Some companies are disclosing the additional information, while others are defending their nondisclosure stance. It remains to be seen whether the SEC ultimately accepts companies' arguments for nondisclosure.

Directors should discuss with management, and carefully consider, how the company approaches its performance-target disclosures. Getting disclosure right in this sensitive area can be challenging, as companies seek to comply with the rules while avoiding disclosing information that may be useful to competitors—especially non-US competitors that don't have the same disclosure obligations.

4. For a description of the executive compensation disclosure rules, see *Current Developments for Directors 2007*, available at www.pwc.com/uscorporategovernance.

The box outlines certain other areas the SEC highlighted from its reviews. Directors should discuss with management how the company's 2008 proxy will respond to the call for enhanced disclosure. Given that the SEC expects companies' proxies will address these recommendations, and that SEC comment letters and company responses become publicly available once the issues are resolved, getting these disclosures right the first time will prevent public airing of any debates between the company and the SEC in this sensitive area.

Selected SEC recommendations on executive compensation disclosures

Compensation Discussion & Analysis:

- Enhance CD&A disclosure to provide better analyses of compensation policies and of how specific compensation decisions were made.
- Refocus descriptions of compensation philosophies by, for example, better describing how awarding one type of compensation impacted decisions on awarding other types of compensation.
- Describe any material differences in compensation between different executives.
- Disclose the rationale for how the company structured material terms and payment provisions in change-in-control and termination arrangements.
- Consider using executive summaries, charts, and tables to make the information more understandable.
- Emphasize information that is material.

Benchmarks: Improve disclosure of how comparative compensation information affected compensation decisions. Disclose the names of companies used in benchmarking analyses, both for total compensation and for individual elements of compensation.

Roles and responsibilities: Disclose in more detail who was involved in making compensation decisions; describe what role, if any, the CEO played; and state the nature and scope of the assignment and the material instructions given to any consultants used.

Compensation committee report: Be sure that the report covers all required elements, including whether the compensation committee reviewed and discussed the CD&A with management.

Also of note, the SEC issued many comments on the decision philosophy for CEO compensation. It asked, among other questions, why a company chose to pay its CEO compensation that is significantly higher than compensation paid to other executive officers, as well as why a company used a multiple of base pay as the basis for calculating change-in-control payments.

Empowering shareholders in compensation decisions

Shareholders, proxy advisory firms, the media, and politicians also reacted to the new compensation disclosures. Shareholders pressed to have greater say in executive compensation packages. The most prevalent shareholder proposal in 2007, according to Institutional Shareholder Services, was for shareholders to have an annual advisory vote on executive compensation. Governance experts anticipate increased interest in “say on pay.”

Say on pay would offer shareholders a vote on executive compensation packages, especially those designed for the CEO. Although the vote wouldn’t be binding, it would clearly signal to directors whether shareholders agree with the company’s pay packages. Congress also is pursuing action on compensation issues. In April 2007, the House of Representatives passed “say on pay” legislation, though it is not certain that similar legislation will pass in the Senate.

The idea of an advisory vote on executive compensation packages is not new—the UK and Australia already allow similar votes. However, for US companies the idea is controversial—proponents believe it gives shareholders an important power, while opponents believe directors, elected by shareholders, should make the complex decisions on executive compensation programs. A few prominent US companies have chosen to adopt “say on pay” policies, and—as we saw with majority voting—it may pave the way for other companies.

In December, the SEC launched an online tool, Executive Compensation Reader, allowing shareholders to compare what 500 of the largest US companies are paying their top executives. The tool also provides links to companies’ proxy statements, which include explanations of executive compensation decisions.

Using compensation consultants

Under the SEC's revised rules, companies must disclose the identity of compensation consultants, the nature and scope of their assignments, key instructions given to them, and whether the compensation committee engaged the consultants directly. Many SEC comment letters asked for more information on the nature and scope of the compensation consultants' assignment, including their involvement in advising on CEO pay and the level of interaction they had with the CEO.

Given shareholder and political scrutiny of the role of compensation consultants, some companies are adopting policies that require compensation consultants to be independent of management, thus allowing them to provide services only to the compensation committee. Why? Partly because several institutional investors sent letters to 25 large companies, asking about services that their compensation consultants were providing to management. Congress also began examining the use of compensation consultants in 2007—focusing on whether a consultant's performance of other services for management correlates to higher levels of executive compensation.

In our view, compensation committees should be allowed to determine the most appropriate compensation consultants to hire for a particular service and consider whether other services provided by those consultants impair independence or increase the overall quality of services provided.

Directors' actions

- Consider the following questions when reviewing draft compensation disclosures:
 - Through the eyes of a shareholder, has the company told the full story?
 - Does the disclosure adequately address how and why executive compensation decisions were made? Does it address concerns raised by the SEC?
 - Is there a demonstrable link between executive pay and meaningful performance measures? Is it clear that executive management will earn incentive compensation only if performance targets are met?
 - Are the directors comfortable with the disclosure of performance targets?
 - If the company has received an SEC comment letter, what is the current status of responding to the comments, what key issues are being discussed, and how will the disclosures change?
 - Do the directors clearly understand the full scope of services provided by the compensation consultants? Has the compensation committee assessed the impact that such services have on the consultants' independence?
- Understand shareholders' concerns and be comfortable with management's planned actions, including how the company intends to address any lobbying for a "say on pay" policy.

Continued push for shareholder empowerment

Proxy access

One of the most hotly debated governance issues in 2007 was proxy access—whether shareholders should have the right to place their director nominees in the company’s proxy statement. In pushing for greater proxy access, shareholders were spurred on by a 2006 US appeals court ruling that questioned the SEC’s longstanding practice of allowing companies to exclude from their proxy materials shareholder proposals relating to the election of directors. In November 2007, the SEC voted to clarify that companies can exclude from their proxy materials shareholder proposals that would result in an immediate proxy contest or provide a process for a future proxy contest. Accordingly, companies will be able to exclude such shareholder proposals in the 2008 proxy season.

Many shareholders were deeply disappointed with the SEC’s vote. Despite the SEC’s stance, certain institutional shareholders are initiating shareholder proposals for proxy access bylaws—largely at companies especially affected by the credit market environment. These shareholders plan to challenge companies’ decisions to block their proposals in court. Such plans suggest the proxy access issue is anything but resolved. For its part, the SEC has stated that it intends to reopen this issue.

For directors, the SEC’s actions do not result in significant change. Uncontested elections are likely to continue, since shareholders who are dissatisfied with company leadership will have to undertake a costly and time-consuming proxy contest to put alternative nominees before shareholders for a vote. That said, directors should not be idle. They should ensure that the company is communicating regularly with key shareholders in an attempt to understand their issues and concerns and is responding appropriately—avoiding the conditions which prompt proxy contests. For example, one prominent company has taken an uncommon approach and is hosting regular meetings between directors and its largest shareholders to discuss the company’s corporate governance policies and practices.

Another reason directors need to consider shareholders’ concerns is that, although it might be difficult for shareholders to run an alternate slate of directors, they always have the easier option of withholding votes. And given the growing prevalence of majority voting policies—which would require a director nominee to receive a majority of “for” votes to be elected—directors increasingly are at risk of being targeted with “no” vote campaigns. Currently, almost half of the S&P 500 companies have adopted majority voting policies, and one institutional investor plans to submit shareholder resolutions on this topic at up to 100 S&P 500 companies.

Expanding the use of technology

The SEC has passed new rules that focus on using technology to support communications with and among shareholders.

Electronic shareholder forums

Electronic shareholder forums provide a simple, real-time way to exchange online company information among shareholders and between management and shareholders. A 2007 SEC rule is intended to remove legal concerns that may have hampered greater use of these forums. The rule specifically addresses liability for statements made in an electronic shareholders' forum and defines what actions would not constitute a proxy solicitation. And, while these forums are intended to facilitate greater interaction between companies and shareholders (as well as among shareholders) about shareholders' interests and concerns, they also could make it easier for shareholders to poll fellow shareholders on issues and organize "no" vote campaigns if companies have adopted majority voting provisions.

E-Proxy

In 2007, the SEC also revised rules to require companies to provide their proxy materials (including annual reports) to shareholders electronically, using one of the models below. The rules make it less costly for companies to disclose proxy materials.

Models:

- Notice only: This permits companies to deliver a paper notice to shareholders, directing them to a website where the proxy materials can be found, as well as providing contact information so they can request a hard copy.
- Full-set delivery option: Although companies may continue issuing printed proxy materials, they also must post proxy materials on a website and send a paper notice directing shareholders to that website.

A company could choose both models—for example, one for certain shareholders and the alternate model for others. The rule is effective January 1, 2008 for large accelerated filers (i.e., companies with market capitalization of over \$700 million), other than registered investment companies. The rule goes into effect on January 1, 2009 for all other companies, including registered investment companies.

The e-proxy rule similarly applies to shareholders making their own proxy solicitations. Thus, it may make it easier for shareholders to engage in a proxy contest, particularly since the rules give shareholders the flexibility to select which other shareholders they wish to solicit in such a contest.

The new shareholder force: sovereign wealth funds

Sovereign wealth funds were barely on the radar screen a year ago. That has changed. These large pools of government-owned investment funds gained prominence in 2007. For example, sovereign wealth funds from Asia and the Middle East provided significant capital infusions to financial institutions that have been under stress from the credit market environment. Although such funds have provided much needed capital, there are concerns about how they will act as they become major shareholders. Will they adopt an activist stance, as some institutional shareholders have done? How does home-country political control influence investment strategies? Will such funds seek ultimate control of the companies they are investing in? One thing is sure—as they take increasingly high-profile positions in major US and European companies, these funds will come under increased scrutiny and pressure to be transparent.

Directors' actions

- Understand shareholders' concerns and be comfortable that management is engaging in constructive dialogue with shareholders about the company's corporate governance policies and practices.
- Determine whether the company is effectively positioned to respond to activist shareholders.
- Discuss with management the company's plans to implement one or both e-proxy models.
- Understand the company's current director-nomination policies and, if shareholders are lobbying for different policies, consider whether a policy change is needed.

Financial reporting developments

Accounting for mergers and acquisitions

In December 2007, the FASB released new standards on accounting and reporting for mergers and acquisitions (M&A) and for consolidations—FAS 141(R), *Business Combinations*, and FAS 160, *Noncontrolling Interests in Consolidated Financial Statements*.⁵ For companies with a calendar year-end, FAS 141(R) applies to acquisitions that close in 2009 and beyond. Changes in accounting and reporting for minority interests also will start in 2009 for calendar-year-end companies.

The last time the accounting for M&A changed, the impact was dramatic—no more pooling of interests or goodwill amortization—altering significantly how some acquisitions were structured. While the changes embodied in these new standards may seem less dramatic, they will influence deal negotiations and deal structures, affect how companies model and evaluate the impact of an acquisition, and change how companies communicate deals to shareholders.

Several of the changes are likely to cause greater earnings volatility due to the expanded use of fair value measurements, which also introduces new valuation complexities.

Companies will make the following key changes, among others:

- Account for more transactions as business combinations
- Expense transaction costs and restructuring charges
- Measure certain earn-out arrangements (contingent consideration) at fair value until they are settled, recognizing changes in fair value in each period's earnings
- Recognize and measure 100% of the assets and liabilities (including goodwill) of the target company at fair value, even in partial acquisitions, as long as the acquiring company obtains control
- Cease recognizing gains or losses on the sale of a subsidiary's shares as long as control of the subsidiary is retained
- Include earnings attributable to both the controlling and minority shareholders in net income
- Apply new accounting treatment for certain acquired assets and assumed liabilities—for example, by
 - Capitalizing acquired in-process research and development (IPR&D) assets
 - Recognizing certain contingent assets and liabilities at fair value
 - No longer recognizing allowances for loan losses on the acquisition date
 - Requiring that adjustments in uncertain tax positions be recorded to earnings instead of goodwill

5. The standards represent the first joint effort by the FASB and the International Accounting Standards Board to develop converged standards. It is important to note, however, that although the standards are consistent with each other, they are not identical.

These changes have many implications. Due diligence will require greater precision, particularly for financial projections used to model acquisitions and for deal accounting. The substantial changes in the accounting for partial acquisitions will bring higher asset and liability amounts onto the balance sheet, changing key operating metrics, such as gross margins, EBITDA, and debt/equity ratios.

Companies also will increasingly seek to finalize their acquisition accounting quickly, in the first reporting period after the deal closes. Why? Because material adjustments to the initial acquisition accounting that are made during the measurement period⁶ will be recorded back to the acquisition date. Thus, companies will have to revise their previously filed financial statements when they report comparative-period financial information in subsequent filings. That, along with the greater use of fair value measures and other estimates, may change the timing of deals. Companies may prefer to close transactions early in a quarter, to provide more time to refine acquisition accounting estimates and, thus, reduce the possible need to revise previous financial statements.

Even companies with no merger activity will be affected by the standards if they have minority interest transactions. Performance measures, financial ratios, and consolidated equity balances are likely to change, and companies will need to evaluate the impact that these changes have on existing contractual arrangements, such as debt covenant calculations.

At PricewaterhouseCoopers, we believe that deal flow will be largely unaffected by the new standards, since deals are influenced more by macroeconomic factors. However, we do anticipate that companies may

- Use earn-outs less frequently due to the earnings volatility that results from changes in their fair value
- Obtain seller indemnifications more frequently as part of the negotiation process
- Be less likely to use equity securities to pay for deals, since the new standards require the value of the securities to be measured at the close of the transaction rather than when the transaction is announced—meaning that deal pricing for accounting purposes won't be known until closing
- Need to provide more transparent communications to shareholders, such as
 - Greater explanation of changes to the purchase price
 - The rationale supporting the fair value measures used
 - Reasons for adjusting the acquisition accounting
 - The link between the restructuring activity and anticipated synergies
 - Earnings volatility stemming from transactions with minority shareholders

6. The measurement period is a period of up to one year during which the initial amounts recognized for an acquisition can be adjusted.

The changes these standards introduce are pervasive. Management will need to reevaluate the customary practices it uses to analyze potential acquisitions and to communicate the company's performance and financial results after an acquisition. Although companies cannot adopt the standards early, we recommend that they start assessing the broader impact of the standards now, including the impact on potential transactions.

Directors' actions

- Discuss with management how the new standards may impact both prior and future acquisitions.
- Be comfortable with management's communications to shareholders on any impact that the standards' implementation will have on acquisitions.

Fair value measurement

In 2006, the FASB issued FAS 157, *Fair Value Measurements*, which gives companies a high-level framework for determining the fair value of assets and liabilities that they are either required or permitted to measure at fair value.⁷ The impact of FAS 157 is pervasive, given the number of accounting pronouncements requiring fair value measures. Among other things, FAS 157 emphasizes that fair value is a market-based measure.

Many financial services companies adopted the standard early, generally for financial instruments. The sub-prime mortgage issues and the credit market turmoil are bringing fair value measures into the spotlight by highlighting the difficulty of measuring financial assets and liabilities that are thinly traded, illiquid, or trade at steep discounts.⁸

Nonfinancial services companies are now assessing the impact of FAS 157. Determining the fair value of nonfinancial assets and liabilities presents numerous implementation challenges—many of these assets and liabilities do not trade in active markets and market inputs generally are not readily available for valuation models. Companies are concerned about implementing the standard, given its complexity and the degree of judgment and subjectivity in the measurement process.

With these concerns in mind, the FASB has agreed to defer the standard's effective date by one year for nonfinancial assets and liabilities that are measured on a nonrecurring basis (e.g., business combinations and impairments). Calendar-year-end companies will have to implement FAS 157 for financial assets and liabilities and recurring nonfinancial assets (such as real estate investments held in pension plans) and liabilities that are measured at fair value in 2008, but will defer applying it to other nonfinancial assets and liabilities until 2009.

7. See a full description of FAS 157 in *Current Developments for Directors 2007*, available at www.pwc.com/uscorporategovernance.

8. See the discussion in the "Implications of the changing credit markets" section.

Directors' actions

- Discuss with management the company's readiness to implement FAS 157 for the applicable assets and liabilities in 2008.
- For the assets and liabilities covered by the deferral, make sure that management is actively involved in addressing the implementation issues so that the company is prepared to apply FAS 157 to those assets and liabilities in 2009.
- Understand the impact that FAS 157 has on a company's financial statements and consider any impact on incentive compensation targets.

Uncertain tax positions—an update

FIN 48, *Accounting for Uncertainty in Income Taxes*,⁹ was issued to standardize accounting for uncertainty in income taxes and to increase transparency around a company's tax positions. FIN 48 took effect for fiscal years beginning after December 15, 2006. In November, 2007 the FASB delayed the effective date for certain nonpublic companies that hadn't yet issued annual financial statements that applied FIN 48—postponing their implementation of the standard until annual periods beginning after December 15, 2007.

Compliance with FIN 48 involves considerable judgment and is likely to require input from, and consensus among, a number of individuals, including the CFO, tax director, general counsel, and possibly outside advisors. The standard's requirements for increased transparency may lead, in turn, to additional inquiries from a variety of interested parties, including tax authorities.

The IRS and other tax authorities are studying FIN 48 disclosures to determine how to use the new information. This may lead to more requests for information about transactions that underlie the disclosures. Concerns have also been raised about the effect of these new disclosures on the IRS policy for tax accrual workpapers. Historically, the IRS has had a policy of requesting tax accrual workpapers—management's documentation that relates to the company's tax reserves and related financial statement disclosures—in limited circumstances, such as those involving potentially abusive transactions. In light of the issuance of FIN 48, the IRS has reaffirmed this policy but is also currently reevaluating it to make sure it continues to be appropriate.

The issue with tax accrual workpapers is illustrated in the *Textron Inc.* case. In 2007, a court upheld Textron's position that its tax workpapers were a protected attorney-client work product and so did not have to be provided to the IRS, even though the company gave its external auditor access to them. The company's history of having appealed and litigated several tax issues, along with the fact that various litigation analyses were reflected in the workpapers, played into the court's decision. However, the debate is not yet over. The IRS has appealed the decision, as well as challenged at least one other company in another court. Also, the *Textron* decision has less relevance in other jurisdictions. Accordingly, it's too early to assess the full impact of the *Textron* case.

9. See a description of FIN 48 in PricewaterhouseCoopers' *Current Developments for Directors 2007*, available at www.pwc.com/uscorporategovernance

On the political front, a US Senate subcommittee sent letters requesting information from a number of major companies about their FIN 48 positions. Much of the information requested focused on the companies' international activities, particularly cross-border transactions. As a result of the subcommittee's focus on FIN 48 information, the IRS may feel additional pressure to request tax accrual workpapers more routinely during audits.

In addition, we expect that disclosures about uncertain tax positions will be a focus of SEC reviews and comment letters as many companies complete their first full year-end reporting following the adoption of FIN 48.

It remains to be seen how each of these matters will unfold. In the meantime, companies should make sure their financial statement disclosures appropriately comply with FIN 48 and that tax accrual workpapers contain the necessary documentation, recognizing they may be subject to inquiries from tax authorities.

Risk management and the tax function

Corporate tax departments have experienced significant change over the past few years. To demonstrate adequate internal control over tax accounting and to address new tax accounting principles, they have shifted priorities from tax planning to compliance and risk management. This change has put pressure on resources and underscores the need for training and effective technology solutions.

We are also seeing tax authorities and lawmakers heighten their scrutiny of transfer pricing, tax credits and incentives, and a wide range of transactions that could be perceived to be motivated by tax considerations rather than economic or business considerations. Increasingly, a company's tax reporting may present reputational risk, as the media, academicians, and others view corporate tax planning with greater skepticism. Accordingly, management and directors understand that greater oversight of tax departments may be warranted. Here are some questions directors may wish to discuss with management and tax executives:

- Who sets the priorities and strategies for the tax department?
- Are compensation and performance measurements aligned with the tax strategy, as well as with the company's overall values?
- Who approves what may be considered tax-advantaged transactions?
- Who approves assertions of business or economic purpose when these are needed to support tax reporting positions?
- How do decisions to litigate tax matters get made?

Directors' actions

- Obtain a general understanding of the significant uncertain tax positions and consider the potential impact on the company and its relations with shareholders, customers, and the public if the positions are challenged.
- Confirm that the board and management concur on the tax-related risk tolerance.
- Consider whether the company has the right resources for handling the challenges that face its corporate tax department.
- Understand any concerns about tax-related internal controls and how those are being addressed.
- Consider whether tax-related financial statement disclosures are both appropriately transparent and protect the positions that the company has taken with tax authorities.

SEC developments

Changing faces

In 2007, two Commissioners announced their departure—Roel Campos and Annette Nazareth. At the time of this writing, the President has not nominated replacements for either Commissioner, creating uncertainty around the two Democratic seats on the SEC. This uncertainty could impact future rulemaking initiatives.

In the Office of the Chief Accountant, Scott Taub left his post as Deputy Chief Accountant-Accounting and was succeeded by James Kroeker. The Chief Accountant for the Division of Corporation Finance, Carol Stacey, also left. She was replaced by Wayne Carnall, a former PricewaterhouseCoopers partner.

Key SEC leaders are likely to change under the new administration that will result from the 2008 presidential election.

Areas of focus

During 2007, the SEC took the following actions, each of which is described in greater detail elsewhere in this publication:

- Issued guidance for management's assessment of internal control over financial reporting and approved Public Company Accounting Oversight Board Auditing Standard No. 5, both of which are intended to ensure the sustainability of Section 404 reporting
- Established the Advisory Committee on Improvements to Financial Reporting (CIFiR) to examine the US financial reporting system and provide recommendations on how to improve its usefulness for investors and reduce unnecessary complexity for US companies
- Eliminated the US GAAP reconciliation requirement for non-US companies that report under International Financial Reporting Standards (as adopted by the IASB)
- Continued to examine whether US companies should be permitted to report under IFRS instead of US GAAP
- Reviewed companies' executive compensation disclosures and provided guidance on improving disclosures
- Adopted rules that let shareholders choose how to receive proxy materials—by Internet or mail
- Maintained the status quo by clarifying the SEC's historical position that management's proxy statement is not the right mechanism for contested elections or for shareholders to propose bylaws that could result in contested elections
- Finalized numerous rules relating to the reporting and registration for smaller companies, making it easier for those companies to raise capital

In 2008, the SEC expects to focus on corporate reporting (including addressing CIFiR's recommendations, IFRS for US companies, and XBRL (eXtensible Business Reporting Language)) and on rules for non-US companies.

Progress on XBRL

XBRL is a standardized Internet “machine-readable” language designed to enhance the electronic communication of business information. One of its purposes is to enable more efficient corporate reporting preparation, consumption, and analysis by participants in the business reporting supply chain—management, investors, analysts, creditors, and accountants. It allows users to search, retrieve, and analyze information that is tagged in XBRL—reducing time, cost, and errors that are commonly associated with the current manual processes of collection, data reentry, validation, and analysis of business information. It also will facilitate the SEC’s review of company filings and allow it to compare information across companies more easily.

The SEC considers XBRL a key priority and is therefore

- Encouraging companies to use XBRL in the SEC’s Voluntary Filing Program
- Upgrading its electronic filing system (EDGAR) to leverage XBRL
- Developing US GAAP taxonomies (“dictionaries” of GAAP reporting concepts)
- Unilaterally applying XBRL to executive compensation disclosures

The Voluntary Filing Program lets companies explore XBRL-related filings in return for predictable and expedited periodic reviews of their registration statements by the SEC. Currently, 50 companies are enrolled in the program. The SEC also has launched the Interactive Financial Report Viewer, which allows users to access XBRL filings made under the voluntary program.

Although filing in XBRL is voluntary at present, there are strong signs that the SEC may mandate XBRL filings. CIFIIR has recommended that the SEC require the 500 largest US public companies to submit XBRL-tagged financial statements, followed by other companies that are “large accelerated filers” one year later—as long as certain conditions are met. It’s possible this requirement could apply to the largest US companies as early as December 31, 2008.

Directors’ action

Discuss XBRL with management to assess the impact and benefits of implementing XBRL and monitor any emerging requirements to report XBRL-tagged financial statements.

Developments impacting auditing

Treasury committee on auditing

Although the audit profession has undergone significant change over the past few years, there remain a number of challenges that impact audit quality, the future of audit firms, and their role in the US capital markets.

In an effort to address some of these challenges and their impact on the trust investors have in financial reporting, the US Department of Treasury established the Treasury Advisory Committee on the Auditing Profession. Former SEC Chairman Arthur Levitt and former SEC Chief Accountant Don Nicolaisen are heading the committee. It is focusing on three areas: (1) the audit profession's ability to attract and retain human capital, (2) the structure and financial resources of audit firms, and (3) audit market competition and concentration.

Human capital

An audit firm's overall quality of service is a direct reflection of its people. Therefore, the hiring, development, and retention of good personnel is crucial to a firm's ability to serve clients effectively and efficiently. Also, as financial transactions become increasingly complex, firms require more specialized resources.

The committee is considering how audit firms can attract the brightest students to the accounting profession and can recruit individuals who are skilled in accounting and auditing. Areas of focus include immigration law; professional experience and educational requirements; accounting curriculum; and independence rules and restrictions.

Structure and financial resources of audit firms

Many legal and regulatory issues are challenging the sustainability of the audit profession. Some fear major litigation may lead to the collapse of another audit firm—with adverse effects in the capital markets—and believe that the way to reduce this threat is to make necessary changes to the legal and regulatory environment. Others are seeking to have audit firms disclose more financial information on a routine basis.

Competition and concentration

A healthy, sustainable, and competitive audit profession is vital. That said, there are competitive barriers to entry, particularly for smaller audit firms. We expect the committee will consider factors that may be discouraging otherwise qualified firms from pursuing larger public company audits.

Independence rules also affect competition and choice. Notably, scope-of-service rules may reduce the number of audit firms eligible to be appointed auditors. In light of this, we expect the committee to reexamine these rules, to ensure that they support audit independence but do not unnecessarily restrict choice for public companies.

Changing auditor independence rules

The Public Company Accounting Oversight Board (PCAOB) continues to consider rules on auditor independence, which will impact audit committees. Although the following rules have not been finalized at the time of this writing, they may apply during 2008.

- The independence rules on providing personal tax services to executives in financial reporting oversight roles are changing—essentially to expand the period in which the company’s auditor is prohibited from providing such tax services.
- Current rules require auditors to communicate to audit committees any relationships between the auditor and the company that might reasonably be thought to bear on the auditor’s independence. The proposed rule would require such communications both before the auditor accepts a new attestation engagement and annually thereafter.
- Another proposed rule would require audit firms that are seeking preapproval for internal control-related nonaudit services to communicate to (in writing) and discuss with the audit committee the proposed services and their potential effect on the auditor’s independence. This proposal is similar to the current rule on providing tax services to companies.

Directors’ action

Ask management and the auditors to provide periodic updates on developments in this area, and change processes, as needed, to comply with the rules once they are finalized.

Section 404 update

The SEC and the PCAOB issued new guidance to improve the effectiveness and efficiency of internal control over financial reporting assessments that management and the auditors perform.

The SEC's guidance for management (effective June 2007) focuses on the internal controls that prevent or detect material misstatement in a company's financial statements. The guidance is intended to be scalable for companies of various sizes and flexible enough that companies may tailor their evaluation procedures to their specific facts and circumstances.

The PCAOB's Auditing Standard 5 applies to fiscal years ending on or after November 15, 2007, with early adoption permitted. AS 5 replaces AS 2 and encourages the auditor to perform a top-down, risk-based approach to auditing the design and operating effectiveness of internal control over financial reporting.

Companies and auditors focused on the impact of the new guidance starting in late 2006, when the proposals were issued. Accordingly, the right-sizing of effort has, for the most part, been incorporated into the 2007 evaluations and audits.

Directors' actions

- Understand the key financial reporting risks the company faces, to better understand the risk-based approach management and the auditors will take under Section 404.
- Review the audit strategy with management and the external auditor, discussing areas where significant judgment was exercised.
- Understand management's evaluation process and the extent to which it supports the external auditors' work.

Other noteworthy developments

The Aspen Principles

The Aspen Institute, working with a group of institutional shareholders, companies, and corporate advisors, devised principles to encourage both companies and investors to develop a longer-term orientation. The Aspen Principles, issued in June 2007, are meant to serve as general guidelines that institutional investors and companies (board directors, especially) can adopt and tailor to their particular circumstances. Selected key elements are shown in the box.

The Aspen Principles

1. Use metrics linking to long-term value creation

- Develop and use forward-looking strategic metrics that focus on
 - Enhancing and sustaining the company's value
 - Recruiting, motivating, and retaining high-performing employees
 - Developing innovative products
 - Managing relationships with key constituents (e.g., customers, regulators, suppliers)
 - Maintaining high ethical and legal standards
- De-emphasize short-term financial metrics (e.g., quarterly EPS)

2. Focus communications between companies and investors on long-term metrics

- Communicate frequently about the company's business strategy, outlook for sustainable growth, and performance, as measured against metrics of long-term success
- Avoid providing or responding to estimated quarterly earnings or other financial targets that are highly short-term, and don't participate in consensus earnings programs that encourage a short-term outlook

3. Align both company and investor compensation policies with long-term metrics

- Have an independent compensation committee oversee executive compensation
- Implement compensation policies that
 - Compensate executives and portfolio managers based on metrics of long-term value creation and based on the results of actions within their control
 - Support long-term value creation—for example, by being largely equity-based and requiring executives to hold that equity, without hedging, for a period beyond the executive's tenure
- Ensure that total compensation is reasonable given the organization's size, strategic position, industry, and organizational pay scale
- Disclose executive compensation information clearly

Directors' action

Consider whether the metrics that the company establishes to evaluate its performance, communications between the company and its investors, and executive compensation policies encourage management to create value over the long term.

Postretirement benefits, including pensions

Pensions and other postretirement benefits continue to receive attention, as many US companies deal with significant unfunded benefit liabilities.

For pension benefits, the new 100% funding requirement set by the Pension Protection Act of 2006¹⁰ takes effect for most companies for plan years beginning after December 31, 2007. Accordingly, many companies with pension plans are considering the extent to which they will have to contribute cash to their pension plans in 2008 to meet the new requirement. If their funding falls short of the 100% target, it may—depending on the amount of the shortfall—place limits on future increases to plan benefits and restrict lump-sum payouts.

Some companies are also looking to reduce or eliminate their obligations to provide other postretirement benefits, such as retiree medical benefits. For example, some are seeking to transfer their obligations to voluntary employees' beneficiary associations. Such arrangements, if properly structured, would move the benefit liabilities and related assets off a company's balance sheet.

On the accounting-developments front, both the FASB and the International Accounting Standards Board (IASB) are reconsidering all elements of pension accounting. Their projects are expected to take three to five years to complete. In 2008, the IASB is expected to issue a discussion paper that will explore, among other things, a new approach to measuring the liability for benefit plans that don't fit neatly into either the defined-benefit or defined-contribution categories.

Directors' actions

- Discuss with management the company's strategy for achieving the 100% funding target for defined-benefit pension plans, and understand whether the credit environment will have any effect on securing financing.
- Understand whether management is considering reducing or eliminating benefits, and consider the potential business, economic, and accounting implications of such actions.

10. See the description of the Pension Protection Act of 2006 in the "Financial reporting developments" section in *Current Developments for Directors 2007*, available at www.pwc.com/uscorporategovernance.

Appendix A

Developments affecting smaller companies

SEC rule changes in 2007 will help smaller public companies raise capital more effectively and ease some of their compliance burden. These measures generally apply to companies that have a public float of less than \$75 million. Among other things, the new rules

- Allow more companies to take advantage of the SEC's scaled-down disclosure requirements
- Shorten the holding period for restricted securities from one year to six months
- Permit certain smaller companies to use shortened registration forms for primary offerings regardless of the size of their public float or the rating of the debt they are offering

Such changes may reduce the cost of capital and make it easier for these companies to access capital markets and to comply with the SEC's reporting requirements.

As for Section 404, companies that are non-accelerated filers generally must provide management's assessment of internal control over financial reporting, starting with fiscal years ending on or after December 15, 2007. Auditor attestations were scheduled to start for fiscal years ending on or after December 15, 2008, but the SEC is proposing that the audit requirement be postponed for an additional year.

Guidance for auditors of smaller public companies

Given particular concerns about the relative cost of Section 404 for smaller companies, the Public Company Accounting Oversight Board published auditor guidance on applying Auditing Standard 5 to such companies. The guidance addresses the challenges involved in performing audits of internal control at a smaller, less-complex company.

The following list presents examples of risks that are particular to smaller companies:

- Extensive involvement of senior management in day-to-day activities, coupled with fewer levels of management oversight, increases the risk of management override of internal controls.
- The smaller number of employees tends to limit the opportunity to segregate incompatible duties within key business processes.
- The challenges in recruiting and retaining individuals with sufficient experience and skill in accounting and financial reporting means it may be difficult to determine the right accounting treatment, especially in complex areas.

Directors' actions

- Discuss the new SEC rules with management, including their impact on the company's financial reporting and capital-raising processes.
- Be prepared to discuss with the auditors the directors' views on the effectiveness of the audit committee's oversight and how management addresses the risk of fraud.
- Be comfortable that management has set the appropriate tone at the top, which establishes the expectation for ethical behavior across the company.
- Understand how management addresses issues stemming from insufficient segregation of duties (e.g., by reviewing transactions, checking reconciliations, or periodically counting assets).
- Make certain that the company has access to the proper complement of finance resources—both internal and external—to handle the reporting responsibilities.

Appendix B

Developments affecting non-US companies

Elimination of the US GAAP reconciliation

In November 2007, the SEC amended its rules to allow non-US companies to file financial statements without reconciling them to US GAAP, provided that the financial statements are prepared in accordance with the English-language version of International Financial Reporting Standards (IFRS), as issued by the International Accounting Standards Board (IASB). These financial statements, as well as the independent auditor's report, must explicitly state that they are in compliance with IFRS as issued by the IASB.

The requirement to use the IASB-approved version of IFRS is meant to encourage the adoption of IFRS as a global set of standards that is applied uniformly from country to country.

The new rules apply to financial statements covering years ending after November 15, 2007 and are effective March 4, 2008.

Of note:

- The elimination of the US GAAP reconciliation requirement for companies using IFRS also applies to
 - Interim financial statements and selected financial data
 - Companies that issue (or are guarantors of) guaranteed debt securities
 - Companies that are required to submit financial statements to the SEC for foreign businesses (as defined in the SEC rules) that are significant acquirees or significant equity investees (In determining "significance," companies will use IFRS, instead of US GAAP.)
- Prior rules relating to auditor qualifications, pro forma information, and financial statement requirements of entities other than the issuer (e.g., significant acquirees, investees, etc.) continue to apply. Likewise, a company's audit must still be performed in accordance with the standards of the US Public Company Accounting Oversight Board.
- When adopting IFRS for the first time, non-US companies will be allowed to present statements of income, changes in shareholders' equity, and cash flows for two years rather than three years. This accommodation, which was to expire in 2007, has been extended indefinitely.
- Oil and gas companies offering securities must continue providing information required by FAS 69, *Disclosures about Oil and Gas Producing Activities*, including unaudited reserve information.

Deregistration

In March 2007, the SEC amended its rules to allow non-US companies to deregister their securities and terminate their reporting obligations under the Exchange Act more easily. Previously, the fairly stringent criteria made it difficult to do so, even when there was relatively little interest in the company's securities among US investors.

Many non-US companies are taking advantage of the new deregistration rules—100 deregistered between June and December 2007.

The box outlines some key features of the new rules.

Overview of deregistration rules

General rules, applicable to all types of securities

A non-US company cannot deregister

- Unless it has been an Exchange Act reporting company for at least one year, is current on all the reports it must submit to the SEC, and has filed at least one annual report
- If it has sold any equity or debt securities in a registered offering in the United States during the preceding 12 months (with certain exceptions)

The company must have maintained a listing for the securities on an exchange in a non-US jurisdiction—constituting its “primary trading market”—for at least one year. The primary trading market must account for at least 55% of the worldwide trading volume during a recent 12-month period.

Equity securities

Fundamentally, a non-US company will be able to deregister and permanently terminate its reporting obligation if it meets certain criteria for average daily trading volume, determined over a specified 12-month period. Alternatively, a company can permanently terminate its registration if the equity securities are held by fewer than 300 US residents.

Debt securities

A non-US company can deregister a class of debt securities and permanently terminate its reporting obligations under the Exchange Act if its debt securities are held of record by fewer than 300 US residents, as determined within 120 days before the company files the deregistration application.

Management's report on internal control over financial reporting

In September 2007, the SEC issued guidance on management's report on internal control over financial reporting (ICFR). The guidance regarding non-US companies clarifies that

- Management should use the company's primary financial statements (i.e., home country GAAP or IFRS) as the basis for planning and determining the scope of its ICFR evaluations.
- If in its primary financial statements a company accounts for an entity differently from how it accounts for that entity in the reconciliation to US GAAP (e.g., consolidating it instead of using the equity method,) that entity should be included in management's evaluation of ICFR based on the primary financial statements.
- If the company is required to reconcile its financial statements to US GAAP, management's evaluation should cover controls over that reconciliation process.
- Management's report on ICFR is expected to include all consolidated entities, even if those entities are consolidated on a proportionate basis. If the company does not have the authority or access to evaluate the internal controls of a proportionately consolidated entity, management should disclose in its report that those entities were not included, and state the reasons.

Appendix C

What Directors Think —2007 survey

PricewaterhouseCoopers and *Corporate Board Member* conduct an annual *What Directors Think* survey to capture directors' views on a number of pressing governance issues. Over 1,000 directors responded to the 2007 survey, which addressed many of the developments covered in this publication, including director/shareholder relationships, majority voting policies, director nominations, CEO compensation, and say on pay.

Highlights of the survey are summarized in the box.¹¹

Shareholder relationships

- Directors rate all shareholders as their most important constituency, followed by institutional investors (a subset of shareholders), customers, creditors, management, and employees.
- 45% say institutional investors are the strongest influence on their board, followed by analysts (32%), and ISS and rating agencies (17%).

Majority voting policies

- 61% say majority voting policies will not have a significant, immediate effect.
- 29% say that over the longer term, boards will see significant changes stemming from majority voting policies.

Director nominations

- 64% say board committees have the most influence in nominating new directors.
- 18% say the full board or the nonexecutive chair/lead director has the most influence in determining director nominees.
- 13% say their company's CEO has the most influence in nominating new directors.

Executive compensation

- 67% say US company boards are having trouble controlling the size of CEO pay.
- 41% say boards and compensation committees will need to take a firm stand to curtail the rapid growth of CEO pay.
- 31% say shareholders and institutional investors will apply enough pressure on companies to control CEO pay growth.
- 76% say providing full disclosure of senior management compensation in the proxy is a positive step for public companies.

Say on pay

- 8% say shareholders should have a vote in approving CEO compensation packages.

11. Highlights of the *What Directors Think* 2007 survey are featured in the Special Supplement, available at www.pwc.com/uscorporategovernance.

Corporate governance information available from PricewaterhouseCoopers

www.pwc.com/uscorporategovernance

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