

2009 Current developments for directors*

Helping you through the challenges ahead



*connectedthinking

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To our clients and friends:

If there is one thing this past year has taught us, it is how interconnected the world is. What started as a subprime mortgage issue in the United States has developed into a worldwide credit crisis, exposing systemic vulnerability across global markets and chinks in the global regulatory framework. We expect that over the course of 2009, there will be hearings and formal inquiries into the causes of the economic crisis, which are likely to result in new regulation and perhaps a new regulatory structure — although at the time of this writing, it's too early to know what form those changes will take. With one party controlling both the Congress and the White House, the Democrats have the power to drive fundamental regulatory change. That said, in the near term, the president-elect's agenda will be directed to a large extent at stimulating the economy.

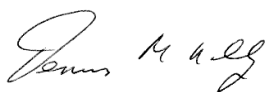
So what does this overall situation mean for your company? For some, it means focusing on liquidity issues and altering cash management approaches, including perhaps bringing in cash from overseas subsidiaries. It could also mean reducing cost structure and considering or extending layoffs, while bearing in mind the impact that any such actions may have on the internal control system. And it sharpens the focus on counterparties — particularly around the challenges a company's suppliers, customers, and business partners are facing in the current economic climate.

One thing is certain: Where we end up when we come out of this situation will be fundamentally different from where we started. Management and boards should look beyond “triage” measures to determine what actions will better position their companies for the future, recognizing that the operating environment might be notably changed. What types of restructured operations, supply chain modifications, new strategies (including for tax planning), and different business models will be needed for companies to be resilient and succeed? How might your company fare under different scenarios?

The economic situation also means it will be a challenging year for financial reporting. Management will have to make judgments and estimates in a markedly different environment — one in which it cannot necessarily rely solely on historical assumptions. Directors will want to understand the reasonableness of and risks associated with significant judgments and estimates, and the transparency of related disclosures.

As for investors, they have seen substantial losses in their portfolios over the past 12 months. They are expected to focus closely not only on year-end results, but also on how companies are responding to the crisis. They will also look to see how directors are overseeing companies' actions, as well as how the board is determining executive compensation. And some financial institutions will need to consider the broader impact of the US government's new equity stakes.

It is sizing up to be an unprecedented year. PricewaterhouseCoopers is committed to helping you understand the issues and work through them. This document not only covers these issues, but also suggests actions for directors. We would be pleased to discuss the contents of this publication and, in whatever ways are helpful, 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 economic crisis	1
Governance and risk management	9
Changing regulatory landscape	16
Trends in governance scrutiny	18
Taxes: What's on the horizon?	22
Financial reporting developments	25
Accounting for mergers and acquisitions	26
Fair value measurement	29
Derivative disclosures	31
Hedging activities	32
Consolidations and transfers of financial assets	32
Loss contingencies	34
Judgment in financial reporting	35
IFRS: A reality for US business?	37
Why care about sustainability?	40
Renewed focus on the Foreign Corrupt Practices Act	43
Developments impacting auditing	46
Developments affecting smaller companies	49
Developments affecting non-US companies	51
Appendix A— <i>What Directors Think</i> — 2008 survey results	55

Implications of the economic crisis

The US economy has gone through a tumultuous year. The largest bankruptcy in US history. The federal government's takeover of major financial institutions. The transformation of investment banks into commercial banks. Intense market volatility.

In this climate, banks have been reluctant to lend, even to one another. Businesses are having difficulty obtaining financing to complete transactions and to fund their daily operations. To restore confidence in the US capital markets and encourage new lending, the federal government has approved the Emergency Economic Stabilization Act and is purchasing equity stakes in key banks, guaranteeing bank debt, supporting money market mutual funds, purchasing mortgage-backed securities, and temporarily increasing FDIC bank deposit limits. And, to help promote consumer spending, the government is supporting the issuance of certain consumer-related asset-backed securities. Companies, meanwhile, are doing their best to cope with waning consumer demand, diminished liquidity, and constrained ability to seize new opportunities as they operate in an uncertain economic environment.

The business impact¹

Liquidity

If the availability of credit remains tight, companies that rely heavily on short-term loans may encounter liquidity issues or find that the cost of capital and financing stays high. Many companies have been surprised at how fast liquidity has dried up, and at how their assumptions about available cash sources may no longer be valid. For instance, some companies that previously used short-term funds as reserves for their current obligations discovered that the funds were no longer accessible. The concern has changed from a return *on* investments to a return *of* investments. Systemic liquidity issues are also affecting deals, and so companies are postponing acquisitions and IPOs.

How should management be evaluating the company's situation? First, assess major sources of liquidity to determine the ease with which funding sources can be tapped, paying particular attention to any material adverse change clauses in current contracts. Also, consider the impact of any collateral-posting requirements, changes in interest rates, covenant compliance, and fluctuations in foreign currency. It would also be prudent to develop contingency plans in case normal operations and current liquidity sources are disrupted.

1. Look for a series of 10Minutes publications on topics that are important for management to address during times of economic and financial stress. These will be issued in late 2008 and early 2009 and will be available at www.pwc.com/10minutes.

One way companies may address liquidity issues is to consider accessing funds from foreign operations. But if a company has asserted that it has indefinitely reinvested unremitted foreign earnings, it needs to proceed cautiously and understand the implications for its tax liability.

Liquidity issues are not just internal to a company. Management needs to be aware of the potential impact on the company's operations if key vendors, customers, strategic business partners, insurers, or counterparties to financial instruments experience reduced liquidity or significant financial deterioration.

Finally, if liquidity issues are particularly acute, management also should consider whether the company will be able to continue as a going concern — and make any related disclosures.

Disclosures

Transparency is more important than ever — investors want to understand what is happening at the company. Do the disclosures allow investors to see the company through management's eyes? Is management being candid, given the fluid nature of the economic situation? How can management provide clarity into its thought processes about assumptions and judgments and help reduce investors' uncertainty?

Indeed, the focus has moved beyond short-term earnings to include the strength of a company's financial position, future revenue assumptions, whom a company does business with, how a company will manage through the crisis — and in certain instances, not just manage, but survive.

As management reacts to this shift in focus, consider enhancing current reporting (including Management's Discussion and Analysis) around

- Risks and uncertainties in light of the current economic environment, including, among other things, the impact on strategy, cost structure, and demand for products and services
- The quality and variability of a company's earnings and cash flows, to help investors determine if past performance might be indicative of future performance
- Major sources of liquidity, as well as a contingency plan if normal sources become less accessible or unavailable
- Events that could affect the company's liquidity and capital resources
- The potential impact of a downgrade of the company's credit rating

- The potential for future material write-downs as a result of market conditions
- Current and projected compliance with debt covenants
- The impact of credit risk and market illiquidity on valuations of financial assets

As a company considers its disclosures, it is important that it cover all significant events up to the date it issues its financial statements.

Pension Funding

The health of many defined-benefit pension plans has deteriorated dramatically, and steep declines in valuations have significantly impacted plans' asset values. In fact, at the time of this writing, Credit Suisse Equity Research estimates more than 300 of the S&P 500 companies have underfunded pension plans and that the funded status of the S&P 500 companies' pension plans may have dropped by more than \$250 billion between January and mid-November 2008.

The declines in funded status may make it challenging for many companies to meet the minimum funding level required by current law, unless the government provides relief. And, the decline in asset values adds liquidity pressure and may adversely affect debt covenants. Actuarial assumptions underlying pensions may change and pension expense for many companies may increase as well.

Internal control

It can be challenging for a company to maintain internal control in a deteriorating economic environment. As management looks to reduce the company's cost structure, it is important to recognize that cost-cutting, layoffs, and employee turnover may put stress on internal control processes.

Additionally, realize that many employees may be under increased financial stress. This means that both management and the audit committee should consider whether there is a heightened risk of fraud and whether current controls are adequate under the circumstances.

Transparency is more important than ever —
investors want to understand what is happening at
the company.

Financial statement considerations

Available-for-sale debt and equity securities: Recoverable?

Many debt and equity securities have experienced significant and extended declines in fair value due to the severity of current economic conditions. The question is, when should a company record an “other than temporary” impairment of its investments? The determination of whether or not a decline in fair value is other than temporary is a judgment call, since the positive and negative factors that must be considered are often subjective. In general, companies will want to determine necessary write-downs by weighing relevant evidence instead of relying solely on predetermined parameters. For instance, defaulting to a pre-established time limit (for example, writing down investments that have been impaired for at least one year) or a percentage loss may not be sufficient.

Additionally, unlike debt securities, equity securities do not have contractual maturities; therefore a company cannot assume it will recover its investments simply by holding them until some future date. As a result, a forecasted recovery of an equity security is typically more subjective than a forecasted recovery of a debt security.

Goodwill and intangibles: Impaired?

In light of recent economic events, the potential for impaired goodwill and intangible assets needs a great deal more focus. Given the substantial decline in equity markets since the start of 2008, companies need to consider whether their market capitalization is below book value. Why? Because it's a sign that the market may have a different view of the value of the company, and it's one indicator that an impairment evaluation of goodwill and intangible assets may be warranted, particularly if the decline persists. In our experience, the SEC also focuses on this area, asking companies to explain how they've considered possible impairment if market capitalization falls below book value.

It is important to note that as companies determine fair value in their goodwill impairment analyses, the assumptions used to project future cash flows probably will need to be adjusted. Given the stagnant economy and tight credit markets, companies cannot automatically assume it's business as usual.

The credit environment's impact extends well beyond financial institutions — few sectors are free from potential exposure.

Deferred tax assets: Valuation allowance?

Companies may need to determine whether a valuation allowance for all or a portion of their deferred tax assets is necessary. Although not a bright-line test, an assessment of whether there are cumulative losses in recent years is a good starting point. If indeed there are cumulative losses, it may be difficult to avoid a valuation allowance. Even companies that do not yet have cumulative losses may nevertheless need a valuation allowance if losses are projected for the near term. Companies should make appropriate disclosures to support either the existence or absence of a valuation allowance.

Making estimates in difficult times

In reviewing significant estimates, directors may find it helpful to discuss

- The process management uses to develop its accounting and financial reporting assumptions, as well as the process for monitoring changes in those assumptions and in the methods used to arrive at them
- How management accumulates, documents, and ensures the reliability of the data underlying its estimates, including market information obtained from third parties
- The reasonableness of management's judgments, including how conservative or aggressive they are, and whether those judgments are based on consistent fact patterns

Fair value reporting for financial instruments

Given market illiquidity, it has been challenging for companies to determine pricing for many of their financial assets and liabilities because recent observable market data has not always been available. As a result, there is debate about the application of fair value accounting during this economic crisis.

Some critics contend that the application of mark-to-market accounting to financial instruments has been a contributing factor in the current credit crisis. They further argue that the current crisis is an anomaly and that, therefore, asset impairment in today's market is not real. Others counter that modifying or suspending mark-to-market accounting for financial assets and liabilities would diminish transparency, and that the current credit market crisis results from economic behavior, not accounting.

The Emergency Economic Stabilization Act (EESA) requires the SEC to study fair value accounting, its possible effect on bank failures, and the impact on the quality of financial information available to investors. The study will also consider possible modifications or alternatives to current fair value accounting standards. The SEC is to submit a report to Congress in early 2009.

Despite calls to suspend fair value, both the SEC and the Financial Accounting Standards Board support its use. They acknowledge, however, that in the current market, companies need to apply more judgment in determining fair value for illiquid assets.

So what should companies that are struggling with valuing financial assets and liabilities do, especially if there is limited market data available? Management needs to apply significant judgment. Key considerations are described in the box.

Valuing assets in a troubled market—key tenets

Bear in mind the following items in any valuation:

- Many companies contend they shouldn't be basing fair values on today's markets, claiming the markets are distressed. But even in distressed markets, not all activity is considered distressed. Therefore, companies must consider the facts and circumstances of individual transactions to evaluate if the transaction price represents fair value.
- Companies should carefully determine whether a transaction was indeed forced or distressed, or whether an imbalance of supply and demand is the true indicator of the asset's fair value.
- Management must supply persuasive evidence to support forced or distressed financial reporting treatment of their transactions.
- Broker quotes are not automatically reliable.

Looking ahead

History shows that major market disruptions lead to legislative responses. The 1929 stock market crash resulted in the formation of the SEC; the savings and loan crisis led to the Financial Institutions Reform, Recovery, and Enforcement Act; and the downfall of Enron and WorldCom spawned the Sarbanes-Oxley Act. The first major legislative response to the current crisis was the EESA, which Congress passed in early October 2008. Of that \$700 billion rescue package, \$250 billion has been committed to purchasing equity stakes in financial institutions at the time of this writing.

With the federal government now owning equity stakes in many of the largest financial institutions, there will be an impact on governance at those institutions. It remains to be seen whether the government will use its ownership stake to influence certain corporate policies. Will it pressure companies to limit executive compensation? Separate the roles of CEO and board chair? Force companies to amend loan terms for individual borrowers?

What seems to be less of a question is whether there will be greater regulatory and shareholder scrutiny of financial reporting and corporate risk-taking. This heightened scrutiny was already evident during recent Congressional hearings about decisions made by financial institutions, rating agencies, and hedge funds. Such questioning is unlikely to abate in the coming months and may begin to expand to companies outside the financial services sector. There also are calls for any new or increased regulation to be considered in a global context.

Directors' actions

- Understand the messages management is delivering to the market, and be comfortable that they are consistent with boardroom discussions about the financial condition and prospects of the company, especially if the company is under economic strain.
- In a similar vein, know what information management is giving to rating agencies, and discuss with management the concerns and areas of focus that those organizations are noting. Although audit committees often already discuss the information going to rating agencies, understand that the nature of the questions rating agencies are asking is changing — they are looking beyond a short-term focus on earnings.
- Discuss with management the collateral and credit risk-related provisions in various contracts to understand the company's commitments and the impact on the level of collateral required if the company's credit rating is downgraded.
- Understand the company's funding position and any concerns about the reliability of funding sources, particularly if company debt is coming due or will have to be renegotiated.
- When discussing management's key judgments, recognize management should not be basing its judgments and assumptions solely on historical experience. Changing times mean that past guidelines and historical measures might not be a reliable basis for predicting the future.
- Take a fresh look at the MD&A and other disclosures, with an eye to the fundamental changes in economic conditions and the extraordinary pressures businesses are under. Pay particular attention to liquidity and compensation disclosures.

Governance and risk management

As 2008 has shown, risk management practices at many companies across a wide range of industries were not as robust or effective as management and directors may have assumed. Few companies anticipated dealing with the scope or severity of the economic shocks. So, many companies are revisiting their approach to risk management — not only to better navigate the current storm, but also to increase their resiliency during future bad weather. Directors also are seeking to improve their oversight of this vital area.

Of course, the past year has many thinking about risk in the context of what can go (and has gone) wrong. However, businesses need to take risks to earn returns for owners. The point is not to avoid all risk-taking, but to take risks that are understood, consistent with the company's strategy, and manageable within acceptable limits.

Why it's so difficult to address risk

It is often difficult to get a handle on risk — not just for directors, but for management. Companies face a continually accelerating rate of change. One way they cope is to build flexibility into their operations, allowing divisional management to respond quickly to changing conditions. But such increased flexibility increases complexity. It makes it harder for centralized management to gain insight into the risk implications stemming from the different ways various divisions may have altered their operations or their products.

How a company organizes its operations can have a major, sometimes unrecognized, impact on risk. As a rule, the more complex the business model, the less transparency management has into the risks being taken across the company or the cumulative impact of those risks. In many companies, the business model has evolved over the years, influenced by mergers, reorganizations, and expansion. The shift may be so gradual that management doesn't recognize the complexity that has developed. For example, to understand the level of complexity, look at the number of business divisions the company has, compared to how many it ideally should have. Or, do the divisions have comparable products, but manage them differently? But even companies with simple structures may face complexity based on where their operations are located around the world or on the complexity of their contractual arrangements.

Perspectives on classifying risk

One way to think about risks is to categorize them as known, unknown, and unknowable. Management tends to spend a significant amount of time using traditional risk management techniques to analyze known risks. Directors' concerns often center more on unknown risks (for example, auction rate securities) and unknowable risks (such as the extent and implications of the current economic crisis). Directors tell us they are less concerned about the risks they are already discussing with management than about the unidentified risks lurking ahead.

Although it is impossible to identify and plan for all unknowable risks, companies can convert many unknown risks into known risks. How? By taking a disciplined approach to identifying events that could drive both expected and unexpected variability in performance and desired outcomes. But how do companies deal with unknowable risks if, by definition, such risks cannot be predicted? In addition to designing a business model that has sufficient flexibility to adapt to change, companies can develop robust business continuity plans and crisis management protocols so that the company is prepared to respond to whatever comes along.

Focusing board efforts around risk management

Enterprise risk management (ERM) is a process that is meant to help a company ensure it can meet its strategic objectives by addressing risks and opportunities across the entire company. While some companies have embraced ERM, the current crisis has exposed weaknesses and vulnerabilities in some of those programs — including in the financial services and retail sectors. When PricewaterhouseCoopers evaluated risk management practices in light of the current economic situation, some themes emerged:

Company culture is paramount: Perhaps the most difficult item for directors to get a sense of is the company's culture. In assessing culture, consider whether the company has

- **Clear accountability** — Do managers throughout the company know what is expected of them and understand that they are responsible for managing risk? When the company acquires new businesses, does it apply the same risk management expectations to the managers of the acquired businesses?

- **Effective communication** — In addition to the routine, operational risks the company faces, are emerging trends and events identified quickly and are issues escalated rapidly? This entails sharing market intelligence and internal knowledge across business units, products, and locations, thereby allowing the entire company to learn from risks in other areas and how those risks are addressed. It also helps to ensure that senior management has a view of risks across the enterprise, instead of myriad, siloed perspectives that can be inadequate.
- **An atmosphere that allows dissent** — Do managers feel comfortable expressing their alternative views on risk? Will their views be considered, or will managers jeopardize their careers by speaking out?
- **Aligned compensation structures** — Do the incentive structures support individuals' taking the right risks and the proper level of risk, while focusing on the company's sustained health and profitability? Does the compensation structure properly reward the individuals overseeing risk?

Compensation considerations

Compensation directly communicates to employees the company's views about the value of their work. Many individuals play a role in overseeing and reporting on the level of risk a company is taking — internal auditors, chief risk officers, compliance officers, business unit controllers, and head office controllers, to name a few. Who determines and funds the base and incentive compensation for these individuals and others in risk governance oversight roles sends a key message. It is generally prudent not to leave the decision to business unit management. They are responsible for delivering business results and managing risk, so they're not in the best position to determine the pay of people who are overseeing and objectively reporting on how well risk is being managed.

Risk appetite is held at acceptable levels: Hold substantive risk discussions between management and the board, so that both are operating with the same definition of risk and agree on the level of risk appetite. This is a difficult area because gauging risk appetite is challenging. Why? First, management and the board may have different ideas about what constitutes risk. Second, it can be difficult for management to describe and quantify some critically important risks (e.g., political or environmental risks) that are nevertheless vital to consider. One reason might be that management doesn't have complete information. Management is often more comfortable engaging in risk discussions that center on easily understandable and quantifiable risks, rather than more complicated, intangible risks.

Product profile: Proceed thoughtfully with new products and services until you're comfortable the company understands the full breadth of the associated risks. Be as alert and skeptical about products that deliver outsized returns as you are about unprofitable products. Consider limiting the proportion of revenue you'll allow from new products until management has proven it can mitigate the associated risks through different business cycles. And require management to put product extensions through the same approval process that new offerings undergo.

Consider the full breadth of counterparties: The economic health of a company often depends substantially on the health of its counterparties. Therefore, a company needs to understand the implications of failures at its suppliers, distributors, customers, insurers, and other counterparties, and determine its tolerance for absorbing such failures. Some companies, however, overlook larger counterparty issues relating to the markets. Does the company depend on foreign exchange or commodities or short-term paper? How resilient is the company in the face of volatility in these markets? Is it hedged properly? If the company assumes that key markets will operate efficiently, what happens if the markets stumble? We witnessed major disruption in the market for auction rate securities over the past year and saw companies struggle to respond to a dramatically different marketplace.

Maintain skepticism: There is an understandable tendency to become complacent in good times, and to have difficulty believing that the bad times will be all that bad or last all that long. Combat this tendency by challenging the scenarios that management contemplates while it is drafting strategy or operating plans. If management's scenarios don't reflect the possibility that a number of things could go wrong at the same time, ask for that analysis. Similarly, if management's worst case scenario is a flat economy, request an analysis of what would happen in a recession. Push against the complacency that historical assumptions and patterns will continue to apply.

Engaging in candid and robust discussions about risk sends a signal to management. The management team might not be in full agreement on where the important risks are; hearing debate among directors may encourage management to continue expressing divergent views in their own meetings.

Rethinking internal audit

Studies show that in recent years, decreases in shareholder value are driven overwhelmingly by strategic, operational, and business issues—not by compliance or financial reporting risks. Yet many internal audit functions remain focused on financial reporting and compliance. Companies may find value in rethinking internal audit’s mandate.

How? By shifting internal audit’s focus toward risks that most often impact shareholder value. That might, for example, mean evaluating business risks relating to the company’s extended supply chain — supplier safety, quality, reliability, and/or viability.

Expanding internal audit’s focus doesn’t automatically add cost. Ideally, such a transformation of internal audit’s effort would involve a concurrent effort to embrace efficiencies in more “traditional” work through, for example, better use of technology as an audit tool.

Risk and rating agencies

One of the major credit rating agencies is incorporating risk management into its ratings. The agency views the adequacy of risk management programs as a key indicator of the effectiveness of the management team. Companies’ ratings may either improve or deteriorate based on the quality of their risk management programs — directly impacting their cost of capital.

With this scrutiny in mind, many companies are re-evaluating their risk management programs. But as mentioned earlier, enhancing risk management doesn’t necessarily mean taking less risk. Risk aversion can inhibit growth. Agile companies will find a way to turn risks that are generally considered threats, such as energy scarcity, into opportunities for creating value, like energy-efficient appliances.

Agile companies will find a way to turn risks that are generally considered threats into **opportunities for creating value.**

Anticipating the extent of risk

Companies with effective risk management are attuned to current and emerging threats, specifically those that might affect their ability to achieve business objectives. For instance, potential water scarcity is a priority for a beverage company but matters less to a computer services company.

Directors might want to discuss with management how much it considers systemic risks in scenario planning, given that these risks could affect the company's long-term success. This planning shouldn't analyze the issues in isolation. For example, if water scarcity becomes dire in a particular area, political unrest and perhaps widespread disease are likely to follow. Thus, management's contingency planning should contemplate what actions the company would take if there were a confluence of risk factors, such as political risk, supply chain risk, and natural disaster risk.

Selected global risks facing multinational companies

- Political risk
- Natural disasters
- Water scarcity
- Pandemics
- Talent shortages
- Activist investors
- Transnational crime and corruption
- Commodity price distortions
- Volatility in energy prices
- Collapsed asset prices
- Demographic shifts
- Climate change

Directors' actions

- Engage in meaningful discussions with management about risk, to align the board's and management's view of the appropriate level of risk the company should be taking, and to provide directors better insight into the key risks and how management is mitigating them. The board may want to hear directly from divisional leaders about the risks they are overseeing.
- Understand how management quantifies individual risks (e.g., operational risk, strategic risk, environmental risk, etc.) and how it assesses risks that cannot be easily quantified.
- Be comfortable that directors bring sufficient knowledge to board discussions about the nature of the company's business and its transactions. This will allow greater insight into the associated risks.

Changing regulatory landscape

Swiftly addressing the financial crisis is a key priority for both Congress and the president-elect. Congress has already begun holding hearings on the financial crisis, trying to understand what went wrong and how to avoid such crises in the future. The hearings will continue into 2009 and are expected to lay the foundation for reviewing and potentially altering the underlying architecture of financial and market regulation — which will have a considerable impact on the financial services sector. As part of the anticipated reforms, some previously unregulated entities such as credit rating agencies, hedge funds, and private equity firms may also face an entirely new regulatory regime. Companies in other industries and sectors could be impacted by the reforms as well — for example, credit rating agencies may interact differently with companies, or financial reporting requirements may change for public companies.

This anticipated overhaul of the current regulatory structure in the United States is likely to have a broad reach, and it could affect the Securities and Exchange Commission, the Treasury Department, the Federal Reserve Board, the Commodity Futures Trading Commission, the Public Company Accounting Oversight Board, and the banking regulatory agencies, among others. While these organizations may see their regulatory authority change, it's too early to predict exactly how. It is clear, however, that Congress will consider the role the SEC played in responding to the financial crisis and whether the SEC's actions, such as those related to short-selling, were helpful.

In addition to changes that are likely to arise from any regulatory overhaul, there will also be key personnel changes at most government agencies, including the SEC. There will be a new SEC chairman and a new team of senior staff advisors. Those individuals will have significant input into and will help implement future regulatory reforms.

Other near-term SEC areas of focus include

- The Congressionally mandated study of fair value accounting, which may, among other things, result in recommendations for any potential changes to fair value accounting standards
- The future of International Financial Reporting Standards, given the recently released roadmap (discussed in the “IFRS: A Reality for US Business?” section)

The anticipated overhaul of the current regulatory structure in the United States is likely to have broad reach.

Trends in governance scrutiny

Institutional investors and union funds have long been active in pressuring companies and boards on governance issues. They now are under pressure themselves, since market conditions and the credit crisis have erased significant value from their portfolios. Companies should be prepared for a contentious 2009 proxy season.

Institutional investors are not alone in evaluating governance today. Regulators, politicians, and the media have similarly been scrutinizing the actions of boards, particularly given the downturn in the economy and its impact on business. The Emergency Economic Stabilization Act (EESA), government ownership stakes in many financial institutions, and the evolving political landscape may all influence further governance changes.

Executive compensation

Executive compensation is one area under fire. Politicians are scrutinizing pay levels, primarily at financial institutions that have failed or been acquired. As a result, the EESA contains specific provisions limiting executive compensation at participating companies, as outlined in the box. Additionally, state attorneys general are examining whether bonuses in 2008 are being funded through government assistance to financial services companies under the EESA. Regulatory activity on executive compensation has also increased in the UK and many countries in western Europe. This activity has been targeted at the financial services sector, although it may spread to other industries in 2009.

Limits on executive compensation

The Emergency Economic Stabilization Act sets certain limits on compensation of the top five senior executives at financial institutions participating in the capital purchase program. The limits take the following forms:

- There can be no severance payments to senior executives that equal or exceed three times the executive's average taxable income for the previous five years.
- Financial institutions are able to "claw back" past bonuses and other executive compensation that had been based on materially inaccurate financial reports.
- Incentives encouraging unnecessary and excessive risks that threaten an institution's value are not allowed. Note there is no definition of what might constitute "unnecessary and excessive risks."
- Institutions are barred from taking tax deductions of more than \$500,000 per year for each of their top five senior executive officers. Note there are no "performance-based" exceptions to this limitation.

Many shareholders believe there is an insufficient link between pay and performance and so continue to voice concerns about executive compensation. Some are especially skeptical about whether directors are setting compensation levels properly, particularly at financial institutions that have suffered significant credit-related losses. Shareholder pressure also continues to build on executive severance arrangements, particularly on potential tax gross-up payments. The depth of shareholder concern is evident in their ongoing push for an advisory vote on executive compensation — i.e., say on pay.

Despite all the interest in say on pay, there were fewer than 80 such shareholder proposals in the 2008 proxy season. Fewer than one in five of the proposals had majority shareholder support, although that may change in 2009, given the significant downturn in financial and market performance. Continuing pressure from shareholders could drive more companies to adopt say on pay, expanding the number of adopters beyond the few companies that currently have say-on-pay policies. There may even be regulatory or legislative action that would grant shareholders more input on executive compensation.

Proxy access

Shareholders continue to seek the right to place their director nominees in the company's proxy statement. Though the SEC originally said it would revisit the question of proxy access in 2008, its attention has shifted to higher priorities. The next SEC chairman will decide with the other commissioners whether to reopen the issue.

However, there were court rulings that affected shareholders' access to the proxy. In July 2008, the Delaware Supreme Court ruled that it is within shareholders' rights to propose director candidates other than the board-sponsored nominees. Shareholders might leverage this ruling to continue pressuring companies to place their director candidates on the proxy. But the court further decided that the company would not be required to pay reasonable expenses associated with the proxy battle, even if the shareholder were to be successful in seating at least some directors.

Market conditions have erased significant value from institutional investors' portfolios. **It may be a contentious proxy season.**

Separating the chair and CEO roles

Separating the roles of the board chair and the CEO remains on shareholders' agendas. Proponents of splitting the roles believe separation allows the CEO to focus on running the business while the chair runs the board. Opponents counter that combining the roles leads to a unity of purpose that benefits the company and its shareholders.

The roles of CEO and chair are combined at 61 percent of S&P 500 companies according to the Spencer Stuart 2008 Board Index, a substantial drop from the approximately three-quarters of companies with combined roles just five years earlier. As part of the fallout from the credit crisis, institutional investors may push more companies to separate these roles.

Directors' actions

- Understand if compensation programs are being modified, and if so, how. Be particularly alert to how shareholders and employees might perceive compensation decisions (including any actions to waive or change performance criteria or to reprice options) in light of the company's performance, share price, and cost-cutting (which might include layoffs).
- Carefully consider the best way to disclose changes in compensation philosophy and approach in the Compensation Discussion and Analysis, recognizing there will be greater shareholder and regulatory scrutiny; this may be especially important if the company is benefiting from the EESA.
- Discuss with management any shareholder pressure to adopt say on pay, and monitor any legislative action. Contemplate whether the company should discuss executive compensation considerations with key shareholders.
- Understand any other sensitive issues for the company's shareholders and be comfortable with the board's role in determining the appropriate response.

Taxes: What's on the horizon?

In 2009, there will be a new administration, single-party control of Congress, continuing economic challenges, and the constraints of a large and growing deficit, all pointing toward significant corporate tax reform over the next four years.

Economic stimulus

An additional economic stimulus package is expected in early 2009, which will attempt to counter rising unemployment and stalled consumer spending, and address homeowner foreclosure concerns. Spending measures might include temporary elements such as further extending unemployment relief, increased funding for food stamps, and low-income energy assistance, as well as longer-term measures such as new infrastructure spending. Tax reductions are likely to focus on low- and middle-income taxpayers, but could also include tax benefits in 2009 that enhance liquidity for businesses and stimulate employment. How? Through job credits for new employees, temporary accelerated depreciation deductions, tax benefits for new “green” investments, temporary relief for required pension funding, and greater opportunity to use net operating losses.

There is concern, of course, about how the government will pay for such an economic stimulus package. The federal deficit — at approximately \$450 billion in 2008 — is expected to grow considerably, with some estimates approaching or exceeding one trillion dollars in 2009 and beyond, even without considering the costs of a stimulus package.

Tax reform

Accordingly, there may be broader tax reform, both to deal with the deficit and to make the tax system more efficient. Many expect tax reform to target individual taxpayers, partly because key tax relief provisions for individuals “sunset” in 2010, and without any changes, individuals will face significant overnight tax increases.

Signs point toward significant tax reform over the next four years.

On the corporate tax side, if the relatively high US statutory tax rate is reduced, reform may be on the table to pay for a rate reduction, as well as to provide a revenue source for some of the new administration's other priorities. Corporate tax benefit measures under scrutiny include eliminating the domestic manufacturing deduction, limiting the deductibility of executive compensation, and limiting the deferral of US tax on foreign earnings (see box). Congress might also repeal LIFO inventory accounting for tax purposes, a move that some have suggested would be consistent with an eventual transition to International Financial Reporting Standards, which do not allow LIFO accounting.

Most of these measures were proposed separately in previous legislation. Companies that studied the possible impact of each proposal found many of these could significantly increase the amount they would pay in taxes, unless Congress offsets the impact of the proposals by reducing the statutory tax rate.

Perspectives on taxing foreign operations

Typically, a US company's worldwide income is subject to US tax. However, income of its foreign subsidiaries is generally subject to US tax only when the earnings are remitted to the United States, thereby deferring US tax on foreign earnings. Some observers are concerned that this deferral encourages companies to expand foreign operations at the expense of US jobs. Others argue that limiting the deferral — essentially increasing effective tax rates — could have unwelcome repercussions for US companies, including the loss of foreign income.

PricewaterhouseCoopers believes that repealing the deferral of US tax on foreign earnings will not encourage US companies to relocate their foreign subsidiaries to the United States, since US companies sell 90 percent of what they produce abroad to foreign customers. If US companies are taxed on the earnings of their foreign subsidiaries, they would face higher taxes than their foreign competitors, calling into question the sustainability of their foreign subsidiaries. Any ensuing disposal of foreign subsidiaries will result in decreased foreign revenue, which could affect US corporate headquarters' staff levels and is likely to reduce US exports to these markets.

Directors' action

Discuss with management how the company might be affected by new tax proposals, and what types of operational changes could minimize any adverse consequences and make operations more tax efficient.

Financial reporting developments

Accounting for mergers and acquisitions

Important changes in the accounting for merger and acquisition (M&A) transactions are here, with new standards taking effect on January 1, 2009, for calendar-year-end companies.² FAS 141(R), *Business Combinations*, and FAS 160, *Noncontrolling Interests in Consolidated Financial Statements*, require companies to (among other things)

- Calculate the purchase price on the day the deal closes, instead of the announcement date, when using equity to pay for a deal
- Value assets and liabilities acquired at fair value, using the definition of fair value in FAS 157, *Fair Value Measurements*
- Expense deal costs when incurred, instead of reflecting those costs in the purchase price
- Expense restructuring costs, instead of capitalizing those costs.

Increased volatility

Companies may experience greater earnings volatility, both during and after an acquisition.

- **Moving stock prices:** Companies issuing equity as part of the purchase price will measure the value of equity securities on the closing date of the transaction, instead of when the deal is announced. If the market prices a company's securities higher or lower over this intervening period, the purchase price will fluctuate. To address this uncertainty, companies may use caps and floors more often in acquisition agreements to protect the acquirers from the impact that stock price volatility may have on the purchase price.
- **In-process research and development (IPR&D):** Companies will no longer write off IPR&D upon acquisition. Instead, they will capitalize and record IPR&D as an indefinite-lived intangible asset on the acquisition date, subject to impairment testing. Companies will need to track the status of individual projects, which may prove time-consuming. If a project is completed successfully, the related IPR&D assets will be amortized through earnings. If a project is abandoned, the IPR&D assets will be written off at that time.

2. See a description of FAS 141(R) and 160 in *2008 Current Developments for Directors*, available at www.pwc.com/uscorporategovernance.

- **Contingent consideration:** Companies will have to record contingent consideration at fair value on the acquisition date, regardless of the likelihood of payment. For certain arrangements, changes in fair value will flow through earnings until the contingency is settled. To avoid earnings volatility, companies may try to structure deals so that the contingent consideration can be classified as equity. Measuring contingent consideration at fair value will also be a challenge because it will require subjective valuation techniques that reflect the facts and circumstances of each arrangement.
- **Effective tax rate volatility:** In the past, if companies were able to release tax valuation allowances as a result of a business combination, they recorded such adjustments to goodwill. Under the new standard, however, these benefits will be reflected in income tax expense. In addition, under the old accounting, if companies adjusted acquired tax reserves after the acquisition, such adjustments impacted goodwill. Going forward under the new model, these adjustments will generally be recorded in the tax provision, directly affecting a company's effective tax rate in post-acquisition periods.

Impact on deal timing

Few deals are happening at the time of this writing, largely due to the credit and economic environment. That said, when markets recover, the new business combinations standard may impact deal timing.

Some companies will push to close deals at the start of a quarter. Why? Because adjustments to initial acquisition accounting may require companies to revise their previously filed financial statements when they report comparative information in subsequent filings. By closing deals near the start of a quarter, companies will have more time to finalize the valuations before issuing quarterly reports, which may lessen the need to revise their financial statements.

Deal-related costs will now be expensed. Given the impact on earnings, companies may delay performing significant due diligence procedures until they have more certainty surrounding the transaction.

Companies may experience greater earnings volatility, both during and after an acquisition.

Valuation challenges

Applying FAS 157, *Fair Value Measurements*, to the majority of assets acquired and liabilities assumed in a business combination will prove challenging for many companies. (See the “Fair Value Measurement” section for more information.)

- **Acquired assets:** Buyers will need to base the fair value of acquired assets on how the assets would be sold in the marketplace (an “exit” price). As a result, companies may place higher values on assets that they do not intend to use or that they plan to phase out. This is likely to call into question the useful lives of such assets and the timing of impairment charges, and will cause higher depreciation and amortization expense in future periods.
- **Liabilities and contingencies:** Because liabilities are not typically traded in active markets, companies will need to use other valuation techniques to determine fair value. Particularly challenging will be the valuation of contingent liabilities (e.g., litigation, environmental matters, and possible product recalls). Accordingly, the FASB is planning to allow companies to use the current accounting guidance (FAS 5) to recognize contingent liabilities if fair value cannot be reasonably determined. The guidance is expected to be finalized in the first quarter of 2009 and will apply to all business combinations beginning January 1, 2009, for calendar-year-end companies.

Given the valuation challenges, companies may need to engage valuation experts. Companies also should be sure to involve their auditors early in the process to give them sufficient time to understand the methods and assumptions used by the experts.

Impact on past deals

Companies with no planned merger activity will still be affected by the new rules.

- Adjustments to tax uncertainties and valuation allowances from past acquisitions will generally be recognized in earnings, rather than as adjustments to goodwill.
- As a result of changes to minority interest (now called noncontrolling interest) accounting, companies that consolidate a partially owned subsidiary will see an impact on financial statement presentation.

Directors' actions

- Discuss with management how changes in the accounting for business combinations will affect the company's financial reporting (including its effective tax rate), both for past deals and future acquisitions, and how management plans to communicate the effects to shareholders.
- Understand how management intends to address the new valuation challenges, including how it will supplement existing resources.
- Discuss with management the impact that the new noncontrolling interest presentation will have on balance sheet and income statement metrics and performance measures, as well as on contractual arrangements such as debt covenants.

Fair value measurement

The credit market crisis has put the spotlight on the application of fair value to financial assets and liabilities, as discussed in the "Implications of the Economic Crisis" section of this publication. FAS 157, *Fair Value Measurements*, first applied to financial assets and liabilities in 2008. Starting in the first quarter of 2009, companies will use the FAS 157 framework when they apply fair value measurements to nonfinancial assets and liabilities under current generally accepted accounting principles.

Applying FAS 157 to financial assets and liabilities has been a challenge for many companies, particularly for financial institutions, given the size of their financial asset portfolios and the economic conditions in 2008. We also expect companies will face difficulty in applying the FAS 157 framework to nonfinancial assets and liabilities. Why? Because the framework requires companies to value assets and liabilities based on how a market participant would use them. Since nonfinancial assets and liabilities are generally not actively traded, it will be difficult to determine who the market participants are and what a market participant would be willing to pay.

One area that will be significantly impacted is the fair value calculation for impairment testing of goodwill and indefinite-lived assets. With our economy in distress, we expect impairments will occur with some frequency in 2009. Plus, using the FAS 157 framework is likely to result in companies' recording larger impairments. Why? Because companies will have to apply the market participant framework, which may cause them to assign greater value to assets other than goodwill in impairment analyses, driving a possible need to write off or reduce goodwill values.

In addition, as more fully described in the “Accounting for Mergers and Acquisitions” section, the new business combinations standard requires companies to use FAS 157 when fair-valuing acquired assets and liabilities. Therefore, companies will no longer be allowed to value only the assets they intend to use. They will need to value all assets acquired, even those that may be of little or no use to them.

Directors’ actions

- Understand which fair value measurements the FAS 157 framework will impact and what the resulting effect is likely to be.
- Understand management’s basis for significant judgments and estimates regarding the fair value of nonfinancial assets and liabilities; the valuation resources it needs; and how it will determine that any valuations provided by third parties are appropriate.
- Discuss with management its framework for and internal control over developing fair value measurements, including the process for developing hypothetical markets, valuation techniques, and market participant assumptions.

PricewaterhouseCoopers’ overall view on the use of fair value

The credit crisis has exposed the challenges of reporting fair value for financial instruments. Those challenges become even more prominent when applying fair value to many nonfinancial assets and liabilities.

With the credit crisis experience fresh in our minds, now is a good time for standard setters, companies, investors, regulators, and other capital market participants to reflect on and debate when to use fair value accounting beyond where it’s already used. As part of that process, the tradeoffs between the relevance to investors, the reliability of the information, and companies’ ability to implement fair value should be considered.

In our view³, the FASB and its international counterpart should not expand the use of fair value beyond where accounting standards currently call for its use, until the ramifications of fair value are fully understood.

3. See PricewaterhouseCoopers’ *10Minutes on Fair Value in Financial Reporting*, available at www.pwc.com/10minutes.

Derivative disclosures

Companies will have to provide more information about their derivative and hedging activities. The new disclosures are intended to help investors better evaluate the effect that derivative instruments — particularly credit default swaps — have on a company's financial position, financial performance, and cash flows.

FAS 161, *Disclosures about Derivative Instruments and Hedging Activities*, was issued in March 2008 and requires companies, for the first annual or interim period beginning after November 15, 2008, to disclose

- Objectives and strategies for using derivative instruments
- The derivatives' fair values, associated gains and/or losses, and losses and/or gains on any related hedged items
- Contract features that are credit risk-related, including the timing and likelihood that cash or collateral will be required
- Information about the volume of derivative activity

In September 2008, the FASB issued additional guidance for sellers of credit derivatives to ensure that they disclose potential adverse effects of changes in credit risk. Starting December 31, 2008, calendar-year-end companies are required to disclose

- The nature and term of credit derivatives, including a description of events and circumstances that will require sellers of the derivatives to pay amounts required by the contracts
- Quantitative information, such as the maximum amount of potential future payments required by the credit derivatives, the fair value of the instruments, and the nature of any related recourse or collateral provisions that would enable the sellers to recover amounts previously paid in connection with the instruments
- The current status of the payment and performance risk associated with credit derivatives and guarantees

Directors' actions

- Update your understanding of the level of risk the company is assuming in its derivatives and hedging activities, including the risk of counterparty nonperformance, and compare that with the board's risk tolerance and expectations.
- Understand how management is preparing for the new disclosures and addressing their impact on internal controls. Also understand the extent to which treasury and risk management functions are involved.
- In light of these new disclosures, discuss with management the approach to communicating with shareholders, analysts, and other parties.

Hedging activities

Although the FASB proposed changes to simplify hedge accounting in 2008, we do not anticipate the proposal will be finalized as initially planned. The FASB will work jointly with the International Accounting Standards Board to address hedge accounting as part of a broader standard on reducing the complexity in the accounting for financial instruments. This is likely to delay any revised hedge accounting guidance until late 2009 or 2010.

Consolidations and transfers of financial assets

In 2003, the FASB issued FIN 46, *Consolidation of Variable Interest Entities*, which requires that a company consolidate an entity if it will absorb the majority of the entity's expected losses or expected residual returns. The credit market crisis has highlighted the lack of transparent information about a company's involvement with variable interest entities, especially those that are not consolidated. Some companies provided financial support to off-balance sheet entities, even though such support was not contractually required. If companies had contemplated the need to provide such support when they initially considered whether to consolidate the entities, the entities might not have qualified for off-balance-sheet treatment.

Qualifying special-purpose entities (QSPEs), as defined in FAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, are generally exempt from the FIN 46 consolidation requirements. Companies can remove financial assets such as mortgages, car loans, and credit card receivables from their balance sheets by transferring them to QSPEs. To qualify as a QSPE, an entity must hold only assets that can be passively managed — i.e., that require little or no decision-making. Also, its activities must be significantly limited and clearly specified in the documents establishing the entity. In reality, few assets are truly passively managed.

In September 2008, the FASB proposed eliminating the QSPE concept and changing how companies determine whether to consolidate a variable interest entity. If finalized as proposed, the changes will take effect on January 1, 2010, for calendar-year-end companies.

A related FASB proposal also requires public companies to provide many new disclosures in their first filing — whether quarterly or annual — after December 15, 2008. This means that all December 31, 2008 filings will have to include

- The judgments and assumptions the company made in determining whether to consolidate a variable interest entity
- The nature of any restrictions on an entity's assets (such as if the entity's assets can only be used to settle the entity's obligations) that the company consolidates
- The nature of and changes in risks associated with the company's involvement with variable interest entities
- The company's continuing involvement with financial assets that it has transferred to another entity in an asset-backed financing arrangement or securitization
- The current and potential effects on the company's balance sheet, earnings, and cash flows of its involvement with variable interest entities and financial assets it has transferred

Directors' actions

- Understand which, if any, entities will need to be consolidated and the likely effect of the consolidation on debt covenants, equity, regulatory capital ratios, and other agreements.
- Discuss with management the company's readiness to provide the new, potentially significant disclosures.

Loss contingencies

In June 2008, the FASB proposed that companies disclose significantly more information about pending litigation and other loss contingencies. This would allow users of financial statements to better assess the likelihood, timing, and amount of future cash flows associated with loss contingencies. Under the proposal, companies would disclose all loss contingencies, unless specific criteria were met. The proposal also presumes that all loss contingencies are estimable.

There is wide-ranging concern that the US legal environment makes developing and presenting such information particularly challenging. For instance, there is legitimate concern about whether the loss contingency estimates companies would make (and disclose) early in the litigation process would be reliable. Companies are also concerned that such disclosure might harm them in pending litigation and that divulging the information — either to the public or their auditors — would breach attorney-client privilege protections.

Substantial opposition to the proposal is driving the FASB to reconsider it in the first half of 2009. If the FASB ultimately decides to issue a final standard, its provisions would go into effect no earlier than December 31, 2009, for calendar-year-end companies.

Directors' actions

- Understand the significant loss contingency risks, and be satisfied with the transparency of the company's current disclosures.
- During 2009, discuss with management its plans to prepare and disclose the required information if a new standard takes effect.

Judgment in financial reporting

Given the dynamic economy, complex transactions, and industry-specific nuances, US accounting and financial reporting guidance cannot and should not be expected to address every situation. As a result, management needs to apply a great deal of judgment in financial reporting.

In addition, investors often find it difficult to decipher the information in financial statements and to understand critical judgments. They are also concerned that financial reporting doesn't always reflect economic reality.

To address these and other concerns, the SEC established the Advisory Committee on Improvements to Financial Reporting (CIFIr) in August 2007; the committee issued its final recommendations in August 2008. One recommendation was that the SEC articulate its framework for assessing the reasonableness of management's judgments.

Key components of CIFIr's recommended judgment framework

In assessing the reasonableness of management's judgments, the SEC would look to see whether management has

- Analyzed the substance and business purpose of the transaction and linked these to the alternative selected
- Looked at the best available information (such as material facts and authoritative accounting literature)
- Understood (and determined that it could defend) the reliability of the assumptions underlying the estimates
- Explored accounting alternatives; assessed the pros and cons of reasonable alternatives
- Explained the rationale behind material estimates
- Applied an accounting method consistent with the accounting treatment of similar transactions
- Clearly and contemporaneously documented the decision-making process for critical items
- Disclosed the material issues or transactions appropriately

Of course, the challenge with applying judgment is that management at different companies may, in good faith, reach different accounting and financial reporting conclusions about similar transactions or events. Although most companies have a framework for reaching judgments, management may wish to compare its framework to CIFIIR's proposal to determine whether the company's methodology could be improved. An enhanced judgment framework may better enable companies to support their financial reporting judgments and substantiate accounting conclusions. Audit committees would also be able to have more robust discussions with management about critical estimates, judgments, and supporting assumptions.

We at PricewaterhouseCoopers believe the SEC should issue guidance on applying judgment in financial reporting. That guidance would encourage management to apply the concepts in the judgment framework and enhance its disclosure, which would benefit investors. Additionally, once the United States moves to a less detailed set of accounting standards, like IFRS, the application of judgment and the recognition that reasonable differences in professional judgment can coexist will take on greater importance.

Rethinking error correction

The SEC also is focusing on materiality in the context of financial reporting restatements. Both CIFIIR and an ad hoc task force investigated these issues, after observing the large number of financial restatements. Whether an error warrants restatement is a judgment call.

Materiality is important in deciding whether errors should result in restatements. CIFIIR recommends that if an error wouldn't change the "total mix" of information available, the company should be allowed to correct the error the next time it files financial information and provide transparent disclosures to investors.

While the SEC embraces CIFIIR's recommendations on judgment and materiality, the timing of any related guidance is uncertain in light of the SEC's all-consuming focus on the economic crisis.

Directors' action

Understand the particularly significant judgments management makes in preparing financial statements and the extent to which management's approach aligns with the framework that the SEC is expected to use.

IFRS: A reality for US business?

International Financial Reporting Standards are becoming the financial reporting language in most major capital markets around the world. More than 100 countries use or are moving to the IFRS framework. The recent market turmoil demonstrates the interconnected nature of economies around the world, emphasizing the benefits of having a common accounting language that is consistently applied. This supports a shift to IFRS in the United States.

The SEC has proposed a roadmap for potential conversion to IFRS. It includes several milestones that, if achieved, may encourage the SEC to proceed with rulemaking that could require larger US companies to adopt IFRS beginning in 2014. The proposal also permits early adoption for certain of the largest US companies in industries that globally use IFRS more than other accounting standards. Beginning with calendar-year-end 2009, those companies would be allowed to adopt IFRS, although the SEC is considering the need for an ongoing reconciliation between US GAAP and IFRS.

The milestones in the proposal call for the SEC to re-examine possible IFRS conversion in 2011 to determine the final roadmap. The determination to move forward with a mandatory transition to IFRS will, in part, focus on whether

- IFRS accounting standards are improved in the interim
- The International Accounting Standards Board changes its governance structure and can secure stable funding mechanisms, permitting it to function independently
- There is an increase in IFRS education and training in the United States
- IFRS interactive data capabilities (XBRL) are improved

Another milestone that will bear on the 2011 decision is the experience of any early IFRS adopters. However, it is unlikely that a meaningful number of companies will elect early adoption until the SEC revisits the roadmap in 2011. Why not? The proposed roadmap is unlikely to be finalized until well into 2009; there is currently no specific date for mandatory adoption; companies need to prepare for the transition; and companies may have to provide an ongoing reconciliation between US GAAP and IFRS.

Although the milestones the proposal includes are achievable, other factors may play a role in the SEC's 2011 decision. Some argue that the economic crisis raises questions about the appropriate level of regulation over the US capital markets. Since IFRS is considered less detailed than US GAAP, some regard a move to IFRS as less regulation. This, coupled with concern about applying IFRS consistently around the world (e.g., whether countries or regions create exceptions to the standards) could slow progress.

Nonetheless, PricewaterhouseCoopers continues to believe that the adoption of IFRS in the United States is inevitable and that the proposed transition dates are attainable and reasonable. If the largest companies have to report under IFRS in 2014, they will be required to present three years of IFRS financial information. Thus, leading practice for these calendar-year-end companies would include being prepared to capture both US GAAP and IFRS data as of the beginning of 2012.

Strategy for conversion to IFRS

- Employ a measured and strategic approach.
- Perform a preliminary study to identify conversion issues relating to the business, accounting, tax, investors, systems, controls, and work-force.
- Consider the most significant conversion activities, and make the investment only if the company- or industry-specific circumstances warrant it.
- Incorporate key IFRS considerations into ongoing business planning to ensure that they are contemplated as changes occur.
- Gauge which aspects of conversion will take the longest, and consider smaller, controlled one-off projects and “easy wins” where desirable.

Directors' actions

- Understand management's strategy to prepare for IFRS conversion and be comfortable with the proposed timing.
- Once management has performed a preliminary IFRS-conversion study, understand major differences between US GAAP and IFRS that are relevant to the company, the key judgments and estimates underlying those differences, significant conversion issues, and the predicted impact on the business.
- Discuss with management how it is incorporating IFRS considerations into key business decisions, especially if significant investments are involved (e.g., information systems).
- Many non-US countries will convert from their local accounting standards to IFRS in the next few years. If the company has significant subsidiaries that will be converting to IFRS, discuss with management how it is overseeing those conversion efforts and the extent to which those conversion efforts are being coordinated so that the ultimate US conversion can leverage investments made elsewhere around the world.

Why care about
sustainability?

Regardless of one's view about sustainability issues or climate change, or however else the debate is framed, companies and directors can no longer ignore the subject.

Many key institutional investors view climate change and related environmental issues as risks that could impact companies' long-term profitability. Accordingly, they have proposed a number of shareholder resolutions that ask companies to provide increased disclosures about carbon emissions, greenhouse gas emissions, and broader sustainability. These proposals often garner between 20 percent and 30 percent support, suggesting they are no longer fringe issues. And almost 400 institutional investors from around the world — representing \$57 trillion in assets — are 2008 signatories to the Carbon Disclosure Project. The project sought detailed information on carbon emissions from S&P 500 companies and analyzed the results from the 321 companies that responded.

Companies' customers and employees also are focusing more on these issues. They are asking questions about carbon footprints and basing economic decisions on perceptions of the relative environmental responsibility of various companies. Media attention — both positive and negative — on environmental issues also influences and reinforces companies' reputations in this area.

Additionally, more federal legislation is expected. Lawmakers introduced more than 200 bills, resolutions, and amendments relating to cap and trade, climate change, and greenhouse gas emissions in the 2007-2008 sessions of Congress. With the new administration entering office in 2009, that activity is unlikely to abate.

So although the current economic crisis may have pushed the sustainability debate somewhat to the back burner, interest in this subject continues even in these challenging economic times.

Many companies outside the United States — particularly those in Europe — voluntarily issue sustainability reports describing the impact of their operations on the environment and their communities. While some US companies already issue sustainability reports, more are planning to do so. One reason is that shareholders are requesting these reports. Another is based on competitive considerations — whether industry peers provide such reports. If management believes it may face future pressure to provide some form of sustainability reporting, it should begin thinking about what would be reported and what changes the company could make so that its reports in the future will be more positive.

Much of this discussion has looked at sustainability as something to which companies must react. Of course, some companies are looking at sustainability differentiators as an opportunity.

The opportunity side of the sustainability equation

Certain companies are investing in climate-related initiatives, expecting they will yield long-term value beyond reputation enhancement. Initiatives that relate to competitive advantage include

- Reducing delivery costs, especially fuel consumption, by rethinking product size and reducing packaging
- Developing waste-recovery and recycling initiatives
- Reducing costs of materials by working with suppliers on sustainability issues similar to the ones noted above

Directors' actions

- Understand external pressures (from shareholders, legislation, and other stakeholders) surrounding sustainability issues and how the company's overall strategy addresses both risks and opportunities.
- Understand the company's current sustainability objectives and management's plans to achieve those objectives.
- Discuss with management the information the company releases about sustainability issues, how management ensures the reliability of that information, and any plans to increase the transparency of the company's activities in this area.

Many institutional investors view environmental issues as risks that could impact companies' long-term profitability.

Renewed focus on the Foreign Corrupt Practices Act

The Foreign Corrupt Practices Act (FCPA) of 1977 was the US government's attempt to stop the bribery of foreign officials, level the playing field in competitive business situations, and restore public confidence in the US business system. Both the Department of Justice and the SEC enforce the FCPA. The past five years alone have seen more enforcement activity than the 25 years before that. In 2007 and 2008, the SEC brought FCPA enforcement actions against more than 20 senior executives.

Why has enforcement increased? One reason is the renewed US focus on money laundering and funding for terrorist organizations. Other reasons include the heightened attention that the downfall of Enron and WorldCom brought to corporate fraud, the expanded use of whistleblower hotlines, and greater international cooperation. Specific enforcement actions have centered on the following areas:

- **Companies' use of third parties (agents, sales representatives, intermediaries) in business transactions:** Extra scrutiny is given to such payments if there is a suspicion that government officials may ultimately receive some of the funds.
- **Facilitation payments:** These are de minimis payments that expedite routine government actions, such as obtaining permits and licenses, and processing visas, work orders, and other government papers. Although the FCPA permits such payments, local law usually prohibits them.
- **Bribery:** Bribes that occur during a bid process have received particular attention.

FCPA penalties have risen dramatically. Companies that don't comply with FCPA provisions face steep criminal and civil penalties (up to \$2 million per violation and the amount the company gained with the violation). If the government determines the violation was intentional, the penalties can increase substantially.

Additionally, courts are examining whether directors are personally liable for failing to properly supervise companies on FCPA matters.

Key FCPA risk factors

- **Where the company does business:** Some countries have a higher likelihood of corruption than others.
- **How the company does business:** Does the business model rely on an internal sales force, or does it use third-party sales representatives or distributors?
- **With whom the company does business:** Special focus is placed on interactions with government officials. The scope of who qualifies as a government official can be unexpectedly wide, including, for example, doctors in countries with government-sponsored health care.

Directors' actions

- Understand how susceptible the company is to FCPA issues, based on the nature and geographic spread of operations, and how management assesses FCPA risk and monitors compliance with the company's standards and policies on FCPA issues.
- Be comfortable that management is identifying and addressing FCPA exposures as changes in the business take place; for example, as the company acquires other companies or enters into joint ventures. Predeal due diligence is particularly important because a company is responsible for any FCPA issues in acquired entities.

FCPA enforcement activity has increased considerably in the past five years. Associated penalties have risen dramatically.

Developments impacting auditing

Audit profession concentration and competition

With four major audit firms in the United States, concern has been raised that the largest US companies may have limited auditor choice.

In 2003, the US Government Accountability Office (GAO) completed an initial study of the impact of audit firm concentration, finding no evidence of diminished competition for audit services. In 2008, the GAO issued a new study on concentration in the market for public company audits. It found that public company executives believe audit quality has improved and that although large companies still have limited auditor choice, this doesn't appear to have significantly affected audit fees.

Although audit fees did rise, company executives attributed the increase to expanded accounting and audit requirements, not to auditor concentration. Therefore, the GAO has concluded that there is no compelling need for action.

The issues of concentration and competition — and their impact on audit quality and effectiveness — were also examined by the Treasury Department's Advisory Committee on the Auditing Profession, which was formed in 2007 and submitted numerous recommendations to the department in 2008. Among the recommendations was the suggestion that the Public Company Accounting Oversight Board (PCAOB) consider developing indicators of audit quality and effectiveness that it would then monitor.

Other Treasury Committee recommendations

The Treasury Committee studied other issues, including human capital matters and the structure and financial resources of audit firms. Recommendations that might impact companies and audit committees more directly include the suggestion that the SEC require companies to disclose additional information on the reasons for changing auditors. The committee also recommends that the PCAOB require that each large audit firm report annually on, among other things, its quality control system and its effectiveness, and on any audit quality indicators the PCAOB may develop.

Auditor independence

The PCAOB has issued Rule 3526, *Communication with Audit Committees Concerning Independence*, which expands on and supersedes Independence Standards Board Standard No. 1, *Independence Discussions with Audit Committees*. Although auditors will continue to provide annual communications on independence, the new rule, effective on September 30, 2008, requires an audit committee to receive — before an auditor accepts an initial engagement — a written description of any relationships between the auditor and the company that might reasonably be regarded as affecting the auditor's independence. The auditor must also discuss with the audit committee the potential effects of the relationships reported.

Before an auditor accepts an initial engagement, the audit committee will receive a report on the auditor's independence.

Developments affecting smaller companies

Over the past year, the SEC has issued new rules for smaller public companies in an effort to help them raise capital more effectively and to ease their compliance burden.

Section 404 audit requirements

In June 2008, the SEC extended the compliance date for audits of internal control over financial reporting (ICFR) for nonaccelerated filers (generally, companies with less than \$75 million in market capitalization). With the extension, calendar-year-end smaller companies will be required to provide an ICFR audit opinion in their December 31, 2009 annual reports.

This deferral will allow the SEC to complete its study of the costs and benefits of Section 404 implementation for smaller companies. The study is meant to help the SEC determine whether its guidance for management and the Public Company Accounting Oversight Board's Auditing Standard 5, *An Audit of Internal Control over Financial Reporting That Is Integrated with an Audit of Financial Statements*, both issued in 2007, are facilitating more cost-effective internal control evaluations and audits. The study's final report will include recommendations on improving the efficiency and effectiveness of Section 404 implementation.

Uncertain tax positions

The FASB issued FIN 48, *Accounting for Uncertainty in Income Taxes*, to standardize accounting for uncertainty in income taxes and to increase transparency around a company's tax positions. Although the rule went into effect for most calendar-year-end companies on December 31, 2006, the effective date for certain nonpublic companies was delayed.

In November 2008, the FASB again deferred the effective date of FIN 48 — this time for *all* nonpublic entities. Calendar-year-end nonpublic companies will need to adopt FIN 48 on December 31, 2009. By that time, the FASB will have provided guidance on the application of FIN 48 by pass-through entities and not-for-profit organizations.

The deferral doesn't apply to nonpublic companies that have already adopted the provisions of FIN 48 in a full set of annual financial statements. It also doesn't apply to nonpublic consolidated subsidiaries of public companies.

Developments affecting non-US companies

The SEC continues to amend rules affecting non-US companies to protect US investors, promote cross-border capital flows, and eliminate barriers to the US capital markets.

IFRS trends

Last year, the SEC amended its rules to allow non-US companies to file financial statements without reconciling them to US GAAP, provided that their financial statements are prepared in accordance with the English-language version of International Financial Reporting Standards, as issued by the International Accounting Standards Board. Of the more than 1,000 foreign private issuers (as of December 31, 2007), nearly 100 have taken advantage of this rule. It is expected that by 2011, more than 600 non-US companies registered in the United States will be using IFRS. This will significantly increase the number of companies that will benefit from the elimination of the reconciliation requirement.

Deregistration

Many non-US companies continue to take advantage of the March 2007 easing of deregistration rules.⁴ In 2007, 100 non-US companies deregistered, and 69 more deregistered between January and October 2008.

Enhanced reporting requirements

For nearly 30 years, the SEC has provided non-US companies with certain accommodations not afforded to US companies, primarily as a result of differences in national laws and accounting regulations. In September 2008, the SEC amended its rules related to non-US companies. The new rules

- Require non-US companies to test their foreign private issuer status only once a year (at the end of the second fiscal quarter), rather than on a continual basis. If a company does not meet the foreign private issuer status on the testing date, it must comply with SEC requirements for US companies, beginning on the first day of the following year. Non-US calendar-year-end companies will begin applying the second-quarter status test in 2009.

4. See a full description of the deregistration rules in *2008 Current Developments for Directors*, available at www.pwc.com/uscorporategovernance.

- Require non-US calendar-year-end companies to disclose changes in and disagreements with their auditors, starting in 2009. This disclosure will be made in annual reports on Form 20-F and in all registration statements filed with the SEC.
- Shorten the deadline for filing annual reports on Form 20-F from six months after year-end to four months after year-end. For calendar-year-end companies, this new filing deadline first applies to the year ending December 31, 2011.
- Require non-US calendar-year-end companies that do not prepare financial statements under IFRS or US GAAP to provide additional, extensive footnote disclosures required by US GAAP and Regulation S-X, starting in 2011.

Exemption from the 1934 Act registration

For many years, the SEC has allowed certain non-US companies to claim exemption from registering with the SEC as long as those companies meet certain requirements, such as falling under maximum US investor thresholds, applying for the exemption, and fulfilling certain paper filing requirements with the SEC. The exemption enables a company to have its equity securities traded on a limited basis in the over-the-counter market in the United States while avoiding registration with the SEC.

The SEC amended these rules in September 2008 to encourage more non-US companies to enter the US market on a limited basis and to allow US investors access to information that those companies have disseminated outside the United States. The amended rules permit a non-US company to automatically claim exemption from registration, as long as certain conditions are met. Those conditions require that a company

- Not be a current SEC registrant that is already required to file or furnish certain reports, including an annual report filed with the SEC;
- Maintain a listing of its equity securities on one or more non-US exchanges, which must account for at least 55 percent of the company's worldwide trading volume during its most recently completed fiscal year; and
- Publish electronically, in English, certain documents, including annual reports, press releases, and other communications distributed directly to securities holders.

A non-US company must become an SEC registrant no later than October 2011 if it doesn't meet the new exemption requirements.

Internal control over financial reporting

The SEC continues to study the costs and benefits of internal control over financial reporting (ICFR) audits for nonaccelerated filers, which generally are companies (US or non-US) with less than \$75 million of worldwide public float. In June 2008 the SEC deferred by one year the ICFR audit requirement for nonaccelerated filers, to give itself time to complete its study. Calendar-year-end companies will now be required to provide an auditor opinion on ICFR, starting with their 2009 annual reports.

Directors' actions

- Discuss with management the company's projected 2009 foreign private issuer status. If it appears that the company may now be required to register with the SEC, discuss management's plans to ensure compliance with SEC reporting requirements.
- If the company files its Form 20-F five or six months after year-end, discuss with management the strategy to file within four months to meet the 2011 deadline.

Appendix A

What Directors Think — 2008 survey results

PricewaterhouseCoopers and *Corporate Board Member* magazine conduct an annual *What Directors Think* survey to capture directors' views on a number of governance issues. Over 1,000 directors responded to the 2008 survey, which addressed many of the developments covered in this publication, including risk oversight, shareholder relations, proxy access, and sustainability.

Highlights of the survey are summarized in the box.⁵

Risk oversight

- 50% say their boards are effective or very effective at monitoring a risk management plan to mitigate corporate exposures.
- 34% want their boards to devote more time to risk management.
- The chief risk officer typically attends board meetings at 8% of companies; 13% of directors believe the chief risk officer should attend.

Shareholder relationships

- Asked to rate who has the most influence on the board, directors chose institutional investors first (49%), followed by analysts (31%), and then ISS and rating agencies (11%).
- 85% of directors believe shareholders should have some access to communicate directly with directors — 37% think all shareholders should have the ability to communicate directly at any time and 21% say that certain major shareholders should be able to communicate with directors during meetings designed for that purpose.

Proxy access

- 94% do not want Congress to enact legislation giving shareholders greater access to the proxy.

Sustainability

- 5% expect their boards to spend much more time on social responsibility issues, including sustainability and environmental issues, than in the past; 34% believe the board will increase the time it spends on these issues, but not by a great deal.
- 6% of boards have a separate social responsibility/sustainability/environmental committee; 5% say their boards should add such a committee.

5. Highlights of the *What Directors Think* 2008 survey are featured in the Special Supplement, which is available at www.pwc.com/uscorporategovernance.

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Corporate governance information available from PricewaterhouseCoopers

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Focuses on US corporate governance developments, with links to relevant PwC and other select publications, most of which are in downloadable format. Also allows ordering of hard copies of most publications.

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