

What we heard at the SEC conference

The 2006 AICPA National Conference on Current SEC and PCAOB Developments (the Conference) was held on December 11, 12, and 13 in Washington, DC. At the Conference, representatives of the Securities and Exchange Commission (SEC or the SEC staff), the Financial Accounting Standards Board (FASB), the American Institute of Certified Public Accountants (AICPA), and the Public Company Accounting Oversight Board (PCAOB) expressed their views on a variety of accounting, auditing, and financial reporting matters, many of which impact retailer and consumer products manufacturers (R&C companies).

The following highlights certain matters from the Conference that you may find of interest during the 2006 annual report/10-K preparation and review process and in keeping abreast of current developments. This summary is not intended to be a comprehensive outline of the Conference. For more coverage, our document, *DataLine 2006-37, Highlights of the 2006 AICPA National Conference on Current SEC and PCAOB Developments* is available on www.cfodirect.com.

Overview

An overriding theme of the Conference was the focus on the complexity of the financial reporting process and how this could be alleviated. The rules-based nature of our current financial reporting model is a key contributor to its complexity. Some accounting standards provide intricate rules, rather than clearly

articulated principles. Greater focus on core principles and concepts, and less focus on bright-line rules and carved-out exceptions, will enhance consistency and reduce opportunities for structuring transactions to achieve an accounting result that is inconsistent with the underlying economics.

Relying more heavily on “principles-based” standards will require preparers and auditors to exercise greater levels of professional judgment, a responsibility they must be willing to assume. Applying professional judgment is one of the primary value propositions that the profession offers to investors.

Management’s discussion and analysis

Management’s discussion and analysis (“MD&A”) is central to achieving the financial reporting objective of full and transparent disclosure. Members of the SEC staff noted a number of areas where companies and their advisors should continue to focus their efforts in order to enhance the quality and usefulness of financial reporting, including disclosures about:

- **Revenue recognition:** The disclosures should enable the reader to understand sources of revenue and related arrangements, consistent with the relevant literature. Disclosures should be consistent throughout the document (i.e., the financial statements, the business section, critical accounting estimates, and MD&A).

- **Forward-looking information:** The MD&A should include forward-looking information about trends, events, and uncertainties that are reasonably expected to have a material effect in the future.
- **Non-GAAP measures:** While there is technically no prohibition against eliminating a recurring item from the calculation of a non-GAAP measure, the SEC staff believes that companies must demonstrate the usefulness of any measure that excludes recurring items, especially if the non-GAAP financial measure is used to evaluate performance.
- **Critical accounting estimates:** Registrants should focus on the judgments and uncertainties that are involved in applying those policies and disclose information about the process used to develop those estimates.
- **Liquidity:** Disclosures should depict all known trends, commitments, events, and uncertainties. Such disclosures should specify both internal and external sources of liquidity.
- **Off-Balance Sheet arrangements:** Disclosures should include the basis for the structure of the transactions, noting the pros and cons that the registrant considered before entering each transaction. The disclosure should specifically state any risk of “material” loss associated with the transaction.
- **Contractual obligations table:** The tabular disclosure should specify

interest and pension obligations if expected future payments are thought to be significant.

Executive compensation

The SEC staff identified the new Compensation Discussion & Analysis (CD&A) as being at the heart of the new executive compensation disclosure rules. While the CD&A includes information on compensation earned in the current fiscal year, companies may also need to consider events that took place before and after the current year in order to provide information that is consistent with a full and fair disclosure of compensation matters. For example, if a stock option grant occurred in February 2007 and was part of a bonus based on 2006 results, disclosure of the grant in the narrative of the 2006 proxy statement would be useful to understand total compensation. Furthermore, the dollar amount recognized for financial statement reporting purposes with respect to the fiscal year should be reported in the Summary Compensation Table for stock and option awards.

As with the previous rules relating to compensation disclosures, the information provided under the new rules may be included directly in the Form 10-K or may be incorporated by reference from the annual proxy statement. In either case, the information remains covered by the CEO/CFO Section 302 certifications and the company's disclosure controls and procedures.

The SEC will have a dedicated team to review the executive compensation disclosures after the proxy season. Thus, the SEC staff recommended that the preparer of the executive disclosures review the financial statement footnotes and supporting documentation to help ensure that information is consistent and accurate.

Stock option grant date issues

As discussed at the Conference, the SEC staff issued guidance in January 2007 regarding restatements for stock option back-dating issues. The purpose of the guidance is to provide relief to preparers, who might otherwise be required to file several amended filings for a number of periods. The SEC staff's guidance discusses the means by which a single current amended filing could report

the year-by-year effects of incorrectly recorded stock compensation expense and the related tax effects, reconciled to beginning retained earnings as restated. The full letter is available on the SEC's website at www.sec.gov.

PCAOB and Section 404

On December 19, 2006, the PCAOB voted to release for comment a proposed new standard to supersede Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (AS 2). A copy of the proposed standard is available at: www.pcaob.org. The proposed standard is subject to a comment period ending on February 26, 2007, after which it must be submitted to the SEC for approval.

On December 20, 2006, the SEC released for comment the proposed interpretive guidance for management's report on internal control over financial reporting. A copy of the proposed interpretive guidance is available at: www.sec.gov. The guidance is subject to a comment period ending on February 26, 2007.

These releases were issued after the Conference; however, multiple speakers focused on Section 404 and how to address the lessons learned from the first two years of applying AS 2. There was substantial coordination between the PCAOB and SEC in developing new guidance and revised standards. In developing its proposed standard, the PCAOB remained committed to four primary goals: (1) a standard that is easier to read, (2) a critical evaluation of every area of the audit of internal control to reduce unnecessary procedures, (3) codification of past guidance regarding efficiency, and (4) emphasis on the control environment.

Hedge accounting/ documentation

The hedge documentation requirements are both extensive and prescriptive. The key message from the SEC staff was to stress the need for companies to carefully review the requirements and prepare their documentation accordingly. The SEC staff commented that documentation is sufficient when it is clear that all the criteria for hedging have been addressed. The SEC noted that there is no bright line

to indicate what is "sufficiently clear," especially for complex transactions, and thus registrants must apply judgment in their evaluation of the required extent of documentation.

The SEC staff discussed two hedging relationships that do not meet the criteria required for the short-cut method: (1) fair value or cash flow hedges of trust preferred securities; and (2) certain cash flow hedges of variable-rate debt that include a call option. The SEC staff does not believe the short-cut method was intended for trust preferred securities because of the option to defer interest payments often included in the structure of these types of securities. The SEC staff also challenged the assertion that a call option included in certain cash flow hedges of variable-rate debt (i.e., debt at current market rates) has no fair value. The SEC staff disagrees with this assertion unless the exercise price of the call option is structured such that it is also adjusted for changes in credit spreads and/or industry sector spreads.

The SEC identified two hedging relationships where they believe the critical terms match method has been misapplied: (1) fair value hedges of interest rate exposure that use an interest rate swap; and (2) hedging relationships in which the settlement date of the forecasted transaction may differ from that of the hedging instrument by a few days. In these circumstances, the SEC staff believes that no hedge accounting should be allowed unless the registrant had contemporaneously performed a quantitative assessment of hedge effectiveness and prepared hedge documentation to support the application of the long-haul method. However, in limited circumstances, the SEC staff indicated that they have accepted the critical terms match approach despite the above shortcomings when preparers have contemporaneously identified the source of ineffectiveness and performed and documented an analysis supporting the assessment that ineffectiveness is *de minimis*.

Two-class method for computing EPS

SFAS 128, *Earnings Per Share* requires the use of the two-class method when (1) there is more than one class of common stock and the classes have different

dividend rates, or (2) there is another security that participates in dividends or undistributed earnings. The SEC staff has noticed that when there is more than one class of common stock, one class generally has higher dividend rates, while the other has more voting rights. The SEC staff believes that regardless of conversion rights, a company with more than one class of common stock should present both basic and diluted earnings per share for each class of common stock in accordance with SFAS 128 par. 61(d).

When a registrant has two classes of common stock, basic and diluted earnings per share may be presented on a combined basis, with appropriate disclosure, if each class has equivalent economic rights and equivalent dividend rights.

Income taxes

Both the FASB staff and the SEC staff addressed disclosure and other common issues that might arise when companies adopt the requirements of FIN 48, *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109*.

The issues addressed included:

- **Level of documentation required:** The level of documentation and effort considered necessary will vary based on the significance and complexity of the issue, as well as the degree of perceived uncertainty in the tax law.
- **Treatment of uncertainties related to timing differences:** The FASB staff stated that uncertain tax positions that relate only to the timing of when an item is included on a tax return should be considered to have met the recognition threshold for purposes of applying FIN 48. Therefore, if it can be established that the only uncertainty is when an item is taken on a tax return, such positions have satisfied the recognition step for purposes of FIN 48 and any uncertainty related to timing should be assessed as part of measurement.
- **Presentation of tax liabilities in the tabular disclosure of contractual obligations, pursuant to S-K Item 303(a)(5):** The SEC staff stated that obligations to taxing authorities generally represent registrants' contractual obligations and should be included in the tabular disclosure of contractual obligations. They further stated that in cases where the year of expected payments is in question, a registrant should make an estimate and provide appropriate disclosure of this uncertainty. The public accounting profession is currently discussing the appropriate reporting requirements with the SEC staff.
- **Policy election for the presentation of interest and penalties and the related preferability letter requirements:** FIN 48 specifically states that classification is an accounting policy election. The SEC staff stated that it would not require the provisions of SFAS 154, *Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3* to be followed if an enterprise changes its accounting policy on interest and penalties upon adoption of FIN 48. Therefore, a preferability letter would not be required. The SEC staff did state, however, that when an enterprise changes its accounting policy subsequent to the accounting period in which it adopts FIN 48, the enterprise is required to follow the provisions of SFAS 154 and a public company must also obtain a preferability letter to change its accounting policy.
- **Interim period effective tax rate calculations:** FIN 48 requires that interest be accrued in the first period the interest would begin accruing according to the provisions of the relevant tax law. Therefore, interest expense should be accrued over time as incurred and be excluded from the annual effective tax rate calculation.
- **SAB 74 Disclosures:** The SEC staff indicated that it expects the disclosures in the Form 10-K that immediately precedes the adoption date of the related accounting pronouncement to be much more specific on the assumption that companies should have made substantial progress in determining the transition effects.

Business combinations

The SEC staff focused on the following topics related to business combinations:

- **Purchase price allocation to unfavorable revenue contracts:** At the date of a business combination, the terms of an acquired entity's in-process revenue

contracts may be less favorable than the terms that could be realized in a current market transaction. In this circumstance, SFAS 141, *Business Combinations* may require an unfavorable contract liability to be recognized. There is an expectation that the contract terms originally negotiated between the acquired entity and its customer represented a market rate of return at the date the contract was entered into. Therefore, an analysis of whether a contract is unfavorable at the acquisition date would usually focus on the intervening events and changes in circumstances that occurred during the period between when the contract was entered into and the date of the acquisition. Absent intervening events or changes in circumstances, the SEC staff can be expected to raise concerns about an assertion that an acquired contract was in an unfavorable position.

- **Purchase price allocation of customer related intangible assets:** While an income approach often provides the most appropriate valuation of acquired customer relationship intangible assets, circumstances may indicate that a different method provides a better estimate of fair value. When determining the appropriate valuation of a customer relationship intangible asset, the SEC staff believes that the first step in the process should be to obtain a thorough understanding of the value drivers in the acquired entity, and then the valuation technique to be utilized would follow accordingly.
- **Application of push-down accounting:** Push-down accounting is required when the parent owns greater than or equal to 95 percent of a subsidiary. Push-down accounting is optional when the parent owns between 80 percent and 95 percent of a subsidiary. Previously, the SEC staff believed that in situations where the parent owned between 80 percent and 95 percent of a subsidiary and the registrant's policy was to not apply push down accounting, a change in policy should only occur if there is a significant event. The SEC staff now believes that push-down accounting is preferable in all circumstances. Thus, a change in policy would now be acceptable absent a significant event.

Multiple element arrangements

The SEC staff has encountered a number of instances where transactions

or agreements, outside of revenue contracts, contained multiple elements. Examples included: i) contract termination agreements; ii) executory contracts including modifications to existing contracts that may have required an upfront payment; or iii) a litigation settlement which required future services or other concessions between the parties.

The SEC staff determined that when analyzing the accounting for these contracts, the considerations should include whether: i) the elements had independent economic value or substance; ii) any of the elements separately would meet the definition of an asset or liability; iii) there are instances where similar elements would be purchased or sold on an individual basis; and iv) the company has a reasonable basis to make an allocation among the elements. As a result of these considerations, these contracts may result in separate accounting for each of the elements present.

Generally, the SEC staff believes that fair value is a more appropriate allocation basis than the stated amounts in the contract for each of the elements.

Valuation techniques under SFAS 157

The FASB staff gave an overview of SFAS 157, *Fair Value Measurements* noting that the new standard defines fair value for financial reporting purposes and should make fair-value measurements more consistent and comparable. The FASB staff emphasized that the key objective of SFAS 157 is that fair value measurements should

reflect market participant assumptions. The standard clarifies that the basis for a fair-value measure is the exit price (i.e., the price received upon the sale of an asset or the price paid to transfer a liability). SFAS 157 also provides a more robust framework for disclosures. The required disclosures are intended to provide users of the financial statements with quantitative information about fair-value measures in order to improve financial statement users' understanding of the associated impact on a company's results of operations, especially for items that companies measure at fair value by using non-observable inputs.

The SEC staff emphasized that the guidance provided by SFAS 157 will help reduce some of the complexity of determining fair-value measures. The SEC staff noted that it is important that both preparers and reviewers read and fully understand the appropriate accounting literature. Companies need to ensure that accounting staff understand how to apply the fair-value measurements, rather than simply outsourcing the valuation to third-party valuation specialists. Companies are responsible for evaluating the competence of their valuation specialists and understanding the importance of company-provided inputs into the valuation process. Companies should also make sure that the valuation specialist understands the accounting requirements of SFAS 157.

PricewaterhouseCoopers Contacts

For more information about the subject of this *QuickBrief!*, please contact:

John G. Maxwell
Americas Retail & Consumer
Industry Leader
973-236-4780

Nadia Alaudini
Americas Retail & Consumer
Industry Partner
513-361-8185

Steven J. Barr
Americas Retail & Consumer
Industry Partner
585-231-6190

www.pwc.com

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