

# Financial Reporting



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## SEC Year in Review

### Overview of Significant 2007 Developments

This letter summarizes many of the 2007 activities at the Securities and Exchange Commission that affect financial reporting. We begin with an overview and then discuss many of the activities in greater detail. Although not the focus of this letter, we also briefly discuss the 2007 activities of the Public Company Accounting Oversight Board, the SEC's Advisory Committee on Improvements to Financial Reporting, and the Treasury Department's Advisory Committee on the Auditing Profession.

### Smaller Reporting Companies

During 2007, the SEC acted on the 2006 recommendations of its Advisory Committee on Smaller Public Companies by proposing and then finalizing rules to extend reporting relief to a newly defined category of registrants called "smaller reporting companies," those with less than \$75 million of public float. These rules eliminated the former category of filers defined as "small business issuers" and the related small business forms, and moved the financial and non-financial reporting requirements for smaller reporting companies from Regulation S-B into Regulation S-X and Regulation S-K, respectively. Other rule changes facilitate capital raising for this group of companies by making delayed primary shelf offerings available to smaller companies and shortening the holding periods for restricted securities. Further, the SEC exempted most compensatory employee stock options from Exchange Act registration requirements. The Commission also proposed changes to Regulation D

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(which applies to exempt offerings) that would allow limited advertising in private offerings of securities to a newly defined category of investors and update the definition of “accredited investors” to account for inflation. Final rulemaking on this proposal is expected in 2008.

### Internal Control over Financial Reporting

The SEC and PCAOB collaborated in an effort to make management and auditor reporting on ICFR more efficient. The SEC issued interpretive guidance for management on evaluating and assessing ICFR and the PCAOB issued a replacement standard on auditing ICFR, *AS No. 5, An Audit of Internal Control Over Financial Reporting That is Integrated With An Audit of Financial Statements*.

Prior to the availability of the SEC’s interpretive guidance, management generally looked to the framework established for auditors set forth in PCAOB’s now superseded Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*, for guidance. The SEC’s interpretive guidance provides management with an approach for conducting an effective and efficient, top-down, risk-based evaluation of ICFR that meets the requirements of the SEC’s rules and generally parallels the concepts in the new, principles-based standard for auditors issued by the PCAOB.

In tandem rulemaking, the SEC amended its rules to confirm that an evaluation of ICFR performed by management in accordance with the interpretive guidance referred to above is one way to satisfy the requirement for management to evaluate ICFR. The auditor attestation rule was simultaneously amended to mirror the reporting

requirements of AS 5 by eliminating the opinion on management’s assessment that was in addition to the opinion on internal control itself. The SEC also defined and codified the terms material weakness and significant deficiency.

In order to allow more time to study the costs of auditing ICFR under AS 5, in January 2008 the Commission proposed delaying for another year (until 2009 for calendar year end companies) the requirement that nonaccelerated filers provide an auditor’s report on their ICFR.

### E Proxies and Electronic Shareholder Forums

The SEC continued its efforts to bring proxies into the Internet age by adopting rules to begin requiring issuers and other soliciting persons to post proxy materials on the Internet. Shareholders, however, still have the option of requesting paper copies. The SEC further supported the use of the Internet for shareholder communication activities by approving rules that support electronic shareholder forums by generally exempting participants from the proxy rules.

### IFRS

In the spring, the SEC began to reassess its roadmap for reaching the goal of allowing foreign private issuers to file IFRS financial statements without reconciling them to U.S. GAAP, which had been targeted for 2009. Based on the progress made in converging IFRS and U.S. GAAP and implementing IFRS and widespread support for eliminating the reconciliation, in November the Commission eliminated the reconciliation requirement for foreign private issuers that file financial statements that comply with IFRS as issued by the IASB. The SEC also issued a concept release to gather input on the possible

use of IFRS by domestic registrants and held two roundtables on this topic in December.

### Staff Guidance

The staff reviewed the executive compensation disclosure of approximately 350 registrants and issued comment letters to those companies. The staff generally asked registrants to provide greater analysis and to explain the *how* and *why* of compensation decisions. These comments were summarized in a report that the staff made available on the SEC’s website in October.

In 2007, the SEC staff issued two Staff Accounting Bulletins. These SABs updated SAB 105, *Application of Accounting Principles to Loan Commitments*, and SAB 107, *Share-Based Payments*. The first, SAB 109, *Written Loan Commitments Recorded at Fair Value through Earnings*, updated the staff’s views on accounting for written loan commitments carried at fair value, indicating that registrants should include in fair value calculations the expected cash flows related to servicing loans. SAB 110, *Share-Based Payments*, extended the use of the “simplified method” to determine the expected term of plain vanilla options. In SAB 107, the staff had projected that by December 31, 2007 there would be adequate information so that determining expected term by averaging the vesting date and expiration date of the option would no longer be necessary. The staff concluded that such information is not always available, and in these instances, registrants can continue to use the simplified method.

### XBRL

The SEC and its Chairman, Christopher Cox, continue to support and champion the utility of XBRL and interactive financial data. The

Commission announced the release of a newly-developed XBRL taxonomy for user review in December. If the results of this review are satisfactory, the SEC is expected to propose rules to phase in mandatory XBRL reporting beginning in 2008.

### Committees

This year two new committees, the SEC Advisory Committee on Improvements to Financial Reporting (also known as CIFIIR or the Pozen Committee) and the Treasury Department's Advisory Committee on the Auditing Profession (also known as the Paulson Committee) began their work. The SEC established CIFIIR to examine the U.S. financial reporting system to identify ways to reduce unnecessary complexity and make financial statement information more useful and understandable to investors. CIFIIR released a preliminary report in January 2008 and is expected to begin issuing final recommendations in the spring. The Paulson Committee's mission is to develop recommendations to sustain the auditing profession. The Paulson Committee's findings and recommendations are expected this summer.

### Personnel Changes

Both the SEC and the PCAOB have had leadership changes during the year. At the SEC, Commissioner Roel Campos left for the private sector in September, and the remaining Democratic Commissioner, Annette Nazareth, left in January 2008. James Kroeker was named Deputy Chief Accountant in February, and Wayne Carnall was named Chief Accountant in the Division of Corporation Finance in November. At the PCAOB, Kayla Gillan, a board member since inception, stepped down in January 2008.

## New Commission Rules

### Smaller Reporting Companies

In December the SEC finalized rule amendments aimed at facilitating capital raising by easing the regulatory burden for smaller reporting companies. Many of the rule changes were based on recommendations made by the SEC's Advisory Committee on Smaller Public Companies in 2006.

### Regulatory Relief (Release 33-8876)

The amendments extended the scaled disclosure requirements available to smaller companies to a larger group of companies. They eliminated the category of filers defined as "small business issuers" and defined a new category, called "smaller reporting companies," that consists of registrants with a public equity float of less than \$75 million as of the last business day of their most recently completed second fiscal quarter. If a registrant does not have a public float, then it is a smaller reporting company if its revenue was less than \$50 million in the last fiscal year. These tests replace the two-pronged test of less than \$25 million of both public float and annual revenues to qualify as a small business issuer.

The amendments moved the scaled financial and non-financial reporting requirements from Regulation S-B to a new Article 8 of Regulation S-X and Regulation S-K, respectively. The only significant change in the content requirements is that smaller reporting companies must provide audited balance sheets for the two most recent fiscal years vs. the one year required by Regulation S-B.

The small business issuer forms (SB-1, SB-2, 10-SB, 10-KSB, 10-QSB) have been eliminated, and smaller reporting companies will now use the same reporting forms as larger reporting companies and indicate their status on a cover page checkbox. These companies will have the option of selecting, on an item-by-item basis, whether to provide financial statements or non-financial information using the smaller reporting company or the larger reporting company rules. This option is available for all disclosure requirements except when the requirement applicable to smaller reporting companies could be more rigorous than the larger company standard. (Item 404 of Regulation S-K, which covers related party transactions, is the only item where the smaller company requirement could be more rigorous.) However, the SEC stressed in the rulemaking release the importance of registrants providing disclosure that permits financial statement users to make period-to-period comparisons.

The amended rules are effective February 4, 2008. Forms 10-QSB and 10-KSB that small business issuers use for periodic reporting will be phased out over the next year. A current small business issuer can either:

1. Continue to file its periodic reports using these forms; or
2. Begin filing its periodic reports on Forms 10-Q and 10-K, complying with the scaled disclosure requirements in Regulations S-X and S-K if it chooses to.

This choice is available until it files its annual report for its first fiscal year ending on or after December 15, 2007. After that, it must file its periodic reports on Forms 10-Q and 10-K. Companies that were not small business issuers but qualify as smaller reporting companies

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may comply with the scaled disclosure requirements in reports filed after the effective date.

The “SB” registration statement forms, SB-1, SB-2, and 10-SB, will be rescinded on the effective date. A smaller reporting company filing a registration statement after this date will be required to file on the appropriate form without an “SB” designation (e.g., S-1, Form 10) and may comply with the scaled disclosure requirements. If a company filed a registration statement on an “SB” form before the effective date and amends it after the effective date, the company must file the amendment on a form without an “SB” designation, but can continue to use the disclosure format and content based on the “SB” form until six months after the effective date.

The amended rules on entering, exiting, and reentering smaller reporting company status are as follows:

- **Entering via IPO** – A company conducting an IPO determines whether it meets the \$75 million public float test using an approach that is different than the approach in Item 10 of Regulation S-B because it considers shares to be sold in the IPO. Such a company multiplies the estimated offering price per share at the time of filing the registration statement by the sum of the number of shares of common stock held by non-affiliates before the offering plus the number of shares to be sold in the offering. Once the issuer has made this eligibility determination, it will not have to re-determine its filing status until its next annual determination date – the end of its second fiscal quarter. This means that registrants do not have to change reporting status in the middle of the registration process. However, based on the results of the initial public offering, registrants can recalculate their public float and rede-

termine their filing status if they register as a larger reporting company and ultimately have a public float of less than \$75 million.

- **Entering by reporting companies** – A larger reporting company that determines it is a smaller reporting company as of the last business day of its most recently completed second fiscal quarter can report as a smaller reporting company on its Form 10-Q for the just completed second quarter. In other words, the company can file as a smaller reporting company immediately.
- **Exiting** – A smaller reporting company that determines it is no longer a smaller reporting company as of the last business day of its most recently completed second fiscal quarter will not be required to satisfy the larger reporting company disclosure requirements until the first quarter after the end of the fiscal year. That is, the smaller reporting company can wait until after its annual report is filed and then begin complying with the larger reporting company disclosure requirements.
- **Reentering** – A smaller reporting company that moves into larger reporting company status will remain a larger reporting company until its public float is less than \$50 million as of the last business day of its second fiscal quarter. If the company does not have public float, it will move back to smaller reporting company status when its revenue drops below \$40 million for its last fiscal year.

The definitions of “smaller reporting company” and “accelerated filer” are similar in that they are both based on whether a registrant has a public float of \$75 million as of the end of its second fiscal quarter. However, the transition rules for determining whether a registrant is a smaller reporting company and the rules for entering and exiting smaller reporting company and

accelerated filer status are not the same. Therefore, it is possible for a company that is a smaller reporting company to also be an accelerated filer and still be required to provide an audit opinion on ICFR.

Under the transition rules for determining whether a registrant is a smaller reporting company, a company is a smaller reporting company if its public float as of the end of its second fiscal quarter preceding the February 4, 2008 effective date of the new rules was less than \$75 million. In contrast, the public float of a company that was an accelerated filer must drop below \$50 million before it can exit accelerated filer status. Thus, an accelerated filer with a public float between \$50 and \$75 million as of the end of its second fiscal quarter preceding February 4, 2008 would qualify as a smaller reporting company but remain an accelerated filer.

There are also differences in the rules for entering and exiting smaller reporting company and accelerated filer status.

- A company entering accelerated filer status must do so at the time it files its next annual report. A company entering larger reporting company status is not required to comply with the larger reporting company disclosure requirements until the first quarter after the end of the fiscal year in which its status changed. Thus a calendar year end smaller reporting company whose public float exceeded \$75 million on June 30, 2008 would be permitted to file its 2008 annual report in accordance with the smaller reporting company disclosure requirements but must file it within 75 days of December 31, 2008.
- The tests to determine whether a company is an accelerated filer are not made until year end. Therefore, a company whose public float was less than \$50 million as of the end of its

second fiscal quarter cannot exit accelerated filer status until it files its next annual report. In contrast, a company entering smaller reporting company status may do so immediately. Thus a calendar year end company whose public float dropped below \$50 million on June 30, 2008 would be permitted to file its June 30 and September 30, 2008 Forms 10-Q in accordance with the smaller reporting company disclosure requirements but must file them within 40 days of quarter end.

The amendments make the scaled disclosure requirements available to foreign companies if they use domestic forms (e.g., S-1, 10-K) and provide financial statements in accordance with U.S. GAAP. They remove the accommodation under which Canadian companies filing as small business issuers had been allowed to provide Canadian GAAP financial statements reconciled to U.S. GAAP.

In conjunction with these changes, the SEC amended Regulation S-X, Rule 3-05, Businesses Acquired and to Be Acquired. Generally, Rule 3-05 requires three years of financial statements if the significance of the businesses exceeds 50%. However, if the target's revenues for the most recent fiscal year are less than a specified amount, then the requirement is reduced to two years. The threshold for allowing two years of financial statements was increased from \$25 million to \$50 million to maintain consistency with the smaller reporting company threshold.

The release is available on the SEC's website at: <http://www.sec.gov/rules/final/2007/33-8876.pdf>. In addition, the SEC has released a guide to complying with the new rules, which is available on the SEC's website at: <http://www.sec.gov/info/small>

[bus/secg/s33-secg.pdf](http://www.sec.gov/info/smallbus/secg/s33-secg.pdf).

### Availability of Delayed Primary Shelf Offerings to Smaller Companies

(Release 33-8878)

The SEC adopted amendments to Form S-3 and Form F-3 to allow smaller companies to use these forms to register primary offerings of securities. Using these forms is desirable because offerings registered on these forms can be conducted on a delayed basis. In addition, they incorporate by reference periodic reports filed after the effective date, thereby eliminating the need for post-effective amendments to address developments after the effective date. These features provide issuers with the flexibility to take securities "off the shelf" and offer them when they choose to. To be eligible to use these forms, a registrant must meet certain criteria. These include being subject to the periodic reporting requirements under the Securities Exchange Act of 1934 and having timely filed all required periodic reports for a period of at least one year immediately preceding the filing of the registration statement.

Prior to the amendments, a registrant was also required to have a public equity float of over \$75 million to use Form S-3 or F-3 to register a primary offering of equity or unrated debt securities. The amendments extended delayed primary shelf offerings to smaller companies by allowing companies that do not have \$75 million of public equity float to register primary offerings using these forms, subject to a limit described below. Companies with a public equity float of less than \$75 million may now register primary offerings using these forms, provided they:

- Have a class of common equity securities listed and registered on a

national securities exchange such as NYSE or NASDAQ (Pink Sheet and Over-the-Counter Bulletin Board companies will not be able to use the forms for primary offerings);

- Do not sell more than the equivalent of one-third of their public equity float in primary offerings in any 12-month period;
- Meet the other registrant eligibility conditions for the use of the form; and
- Are not shell companies and have not been shell companies for at least 12 calendar months before filing the registration statement.

An issuer that would exceed the one-third cap is temporarily prohibited from using Forms S-3 or F-3 for offerings to raise capital but would still be permitted to register a primary offering using Form S-1.

The amendments became effective on January 28, 2008.

The release is available on the SEC's website at: <http://www.sec.gov/rules/final/2007/33-8878.pdf>. In addition, the SEC has released a guide to complying with the new rules, which is available on the SEC's website at: <http://www.sec.gov/info/smallbus/secg/s33-secg.htm>.

### Revisions to Rule 144

(Release 33-8869)

In order to facilitate capital raising via private offerings, the SEC shortened the holding periods that must be met before restricted securities can be resold under Securities Act Rule 144. The holding period was shortened to six months for non-affiliated investors in reporting companies, and to 12 months for non-affiliated investors in non-reporting companies. The amendments are effective on February 15, 2008, and are applicable to resales of securities that

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were acquired prior to or after that effective date.

The release is available on the SEC's website at: <http://www.sec.gov/rules/final/2007/33-8869.pdf>.

### Exemption of Compensatory Employee Stock Options from Exchange Act Registration

(Release 34-56887)

The Commission amended its rules to exempt companies with compensatory employee stock options meeting certain conditions from Exchange Act registration requirements. Prior to the amendments, companies with over 500 option holders and \$10 million of assets were required to register and report. The exemption applies to an issuer's compensatory employee stock options but does not extend to the class of securities underlying those options. The rules became effective December 7, 2007.

The release is available on the SEC's website at: <http://www.sec.gov/rules/final/2007/34-56887.pdf>.

### Revisions to Form D

(Release 33-8891)

Form D is an informational form that companies file to report that securities were sold without registration and provide information about the offering. The SEC voted to update the information requirements of Form D and mandate electronic filing of the form. The phase-in period for electronic filing will begin on Sept. 15, 2008, and electronic filing will become mandatory on March 16, 2009.

The release is available on the SEC's website at: <http://www.sec.gov/rules/final/2008/33-8891.pdf>.

## Internal Control Reporting

(Releases 33-8809 and 33-8829)

In conjunction with issuing interpretive guidance for management and the PCAOB issuing AS 5 as discussed below, the SEC adopted rule amendments that:

- Confirm that a management evaluation of internal control over financial reporting that complies with the SEC's interpretive guidance issued in June 2007 is one way to satisfy the requirement for management to evaluate the effectiveness of internal control over financial reporting;
- Revise the auditor attestation rule to require only one opinion on the effectiveness on internal controls (i.e., eliminating the requirement for an auditor's opinion on management's assessment); and
- Define and codify the terms "material weakness" and "significant deficiency" and align them with the PCAOB's definitions. Under the new rules, a material weakness is defined as a deficiency, or a combination of deficiencies, in ICFR such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis. A "significant deficiency" is "a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the registrant's financial reporting."

The releases are available on the SEC's website at: <http://www.sec.gov/rules/final/2007/33-8809.pdf> and <http://www.sec.gov/rules/final/33-8829.pdf>.

## Proxies

### E Proxy Access

(Release 34-56135)

In July, the SEC adopted rules that continue the shift toward delivering proxy materials using the Internet. In 2006, the SEC adopted rules giving issuers the option to provide access to proxy materials via the Internet. In 2007, the SEC adopted rules that require issuers to do so. The rules adopted in 2007 require issuers and other soliciting persons to post their proxy materials on an Internet website and provide shareholders with a notice of the Internet availability of the materials. Shareholders can choose the means by which they access proxy materials. The issuer or other soliciting person may choose to furnish paper copies of the proxy materials along with the notice. If the issuer or other soliciting person chooses not to furnish a paper copy of the proxy materials, a shareholder may request delivery of a copy at no charge. Large accelerated filers are required to comply with the rules for proxy solicitations commencing on or after January 1, 2008. Other issuers and persons have the option of complying with the amendments at that time and are required to comply commencing on or after January 1, 2009.

The release is available on the SEC's website at: <http://www.sec.gov/rules/final/2007/34-56135.pdf>.

### Shareholder Proposals

(Release 34-56914)

After proposing two conflicting amendments in July, the SEC adopted rules codifying its current interpretation of its shareholder proposal rule in December. SEC rules provide shareholders with an opportunity to place certain proposals in a company's proxy materials for a vote

at an annual or special shareholder meeting. The amended rule clarifies that registrants can exclude certain shareholder proposals related to the election of directors from a company's proxy materials covering a vote at an annual or special meeting of shareholders. The rule is effective January 10, 2008.

The release is available on the SEC's website at: <http://www.sec.gov/rules/final/2007/34-56914.pdf>.

### Electronic Shareholder Forums

(Release 34-57172)

In November, the Commission approved new rules designed to facilitate the use of electronic shareholder forums for shareholder to shareholder and issuer to shareholder communications. The new rules clarify that issuers and shareholders are entitled to maintain such forums, provided they otherwise comply with federal and state securities laws and the issuer's charter and bylaws.

The new rules provide an exemption from most of the proxy rules for any participant in an electronic shareholder forum as long as the communications occur more than 60 days prior to the announced date of the shareholders meeting and the communicating party does not solicit proxy authority while relying on the exemption. If the meeting date is announced less than 60 days before the meeting, then the exemption ceases to apply two days after the announcement. A participant may solicit proxy authority after the exemption is no longer available if the solicitation is conducted in accordance with Regulation 14A.

The rules are effective February 25, 2008.

The release is available on the SEC's website at: <http://www.sec.gov/rules/final/2008/34-57172.pdf>.

### Foreign Private Issuer Relief and IFRS

The SEC took significant actions during 2007 to promote participation in the U.S. capital markets by foreign private issuers and the use of International Financial Reporting Standards.

### Deregistration and Termination of Reporting Obligations

(Release 34-55540)

In March, the SEC adopted rules to make it easier for foreign private issuers to terminate their reporting obligations under the Exchange Act and to deregister. The SEC views foreign private issuers as potentially more willing to register securities if the process for deregistration were simpler. An issuer is eligible for such relief if its average daily trading volume (ADTV) in the U.S. is no greater than 5% of its ADTV worldwide over a recent 12 month period. Prior to this amendment, a foreign private issuer could only terminate its Exchange Act reporting requirements if it had fewer than 300 holders of its securities who were U.S. residents. Foreign private issuers now have two bases to terminate registration and reporting obligations, ADTV or number of security holders. The amended rules provide a defined, expedited process for terminating registration and reporting obligations. The rules became effective June 4, 2007.

The release is available on the SEC's website at: <http://www.sec.gov/rules/final/2007/34-55540.pdf>.

### IFRS Financial Statements Without Reconciliation to U.S. GAAP

(Release 33-8879)

In November, the SEC amended its rules to allow foreign private issuers that prepare financial statements in accordance with IFRS as issued by the IASB to file financial statements without reconciling them to U.S. GAAP. The revised rules apply to financial statements for fiscal years ending after November 15, 2007. The SEC accelerated its action plan for accepting IFRS as issued by the IASB financial statements without reconciliation from its planned date of 2009. According to a Commissioner, the acceleration was due to the achievement of three threshold issues – the process towards convergence was sufficiently robust; IFRS was being consistently and faithfully applied; and the processes of the IASB as the international standard setter were fair and transparent. The effective date of the amended rules is March 4, 2008. The SEC staff has encouraged any foreign private issuer that wants to file its Form 20-F prior to that date to call the staff to discuss the need for a reconciliation.

The release is available on the SEC's website at: <http://www.sec.gov/rules/concept/2007/33-8879.pdf> and guidance regarding filings before the effective date is available at: <http://www.sec.gov/divisions/corpfin/guidance/cf20fgaap.htm>.

## Proposals

### Revisions to Regulation D

(Release 33-8828)

The remaining smaller reporting company proposal outstanding at the end of 2007 was the one relating to revisions

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to Regulation D regarding private offerings. The proposed rules would allow limited advertising in connection with private offerings of securities to a newly defined category of investors. The proposed rules would also adjust the definition of “accredited investors” to account for inflation. The definition of accredited investor has not been updated since 1982.

The release is available on the SEC’s website at: <http://www.sec.gov/rules/proposed/2007/33-8828.pdf>.

## Use of IFRS by Domestic Filers

(Release 33-8831)

In August, the SEC issued a concept release to gather input on the idea of allowing U.S. registrants to file financial statements prepared in accordance with IFRS as issued by the IASB instead of U.S. GAAP. The SEC received approximately 80 comment letters, and respondents generally supported the idea. However, the respondents differed strongly on the best strategy for achieving that goal. Possible strategies include staying with the current longer-term FASB/IASB convergence program or providing domestic registrants the option of filing financial statements prepared in accordance with IFRS as issued by the IASB in the near term. In December, the SEC held two roundtables to further consider the concept release. If the Commission decides to pursue this, the next step will likely be to propose rules.

The Release is available on the SEC’s website at: <http://www.sec.gov/rules/concept/2007/33-8831.pdf>. The Roundtable transcripts are available on the SEC’s website at: [\[rsround121307-transcript.pdf\]\(#\). A speech by Deputy Chief Accountant Julie Erhardt, which discusses feedback on the concept release and implementation strategies, is available at: <http://www.sec.gov/news/speech/2007/spch121007jae.htm>.](http://www.sec.gov/spotlight/ifrsroadmap/if</a></p></div><div data-bbox=)

## Incorporation by Reference in Form S-11

(Release 33-8871)

In December, the SEC proposed an amendment to Form S-11 to allow registration statements filed on that form to incorporate by reference previously filed information. Form S-11 is an S-1-like form used by real estate entities to register securities offerings. The Securities Offering Reform rulemaking that became effective in 2005 introduced incorporation by reference to Forms S-1 and F-1 for reporting issuers that are current in filing their Exchange Act reports and have filed at least one annual report (e.g., Form 10-K). The same requirements would apply to S-11 filers, and like the S-1 and F-1 issuers, the S-11 issuers:

- Could not be, or have been (including predecessors) for the past three years, blank check issuers, shell companies, or penny stock issuers; and
- Would be required to make their incorporated Exchange Act reports and other materials readily accessible on the Internet. The proposed rules would not permit incorporation by reference of Exchange Act reports and materials filed after the registration statement is effective, that is, they would not allow what is known as “forward incorporation by reference.”

The release is available on the SEC’s website at: [\[posed/2007/33-8871.pdf\]\(#\).](http://www.sec.gov/rules/pro-</a></p></div><div data-bbox=)

## Oil and Gas Reserve Information

(Release 33-8870)

In December, the Commission published a concept release on possible revisions to its disclosure requirements relating to oil and gas reserves.

The SEC published the release to obtain information about the public’s interest in revising the oil and gas reserves disclosures required by Regulations S-X and S-K. Rule 4-10 of Regulation S-X prescribes the financial and reporting standards for companies engaged in oil and gas producing activities and was adopted in 1980. Item 102 of Regulation S-K requires that registrants disclose their proved reserves and prohibits them from disclosing other categories of reserves and was adopted in 1982. The Commission’s proved reserves definitions are those used by the Department of Energy in 1978 and were based upon definitions used by the Society of Petroleum Engineers and the general industry at that time. Since the 1980s, there have been significant technological advancements, changes in the oil and gas markets, and changes in the types of projects in which registrants invest. Consequently, the SEC is seeking comment on the need to update its oil and gas reserves disclosure requirements and related issues.

The release is available on the SEC’s website at: <http://www.sec.gov/rules/concept/2007/33-8870.pdf>.

## Auditor Reporting on ICFR

(Release 33-8889)

In January 2008, the Commission proposed a one-year delay in the requirement for auditors of non-accelerated filers to report on their internal control. Chairman Cox had previously announced the proposed deferral in testimony before the House Small Business Committee in December 2007. The deferral was proposed in conjunction with a cost benefit study the SEC staff will perform of the auditor attestation requirement regarding ICFR for smaller companies.

The study will collect and analyze cost and benefit data from a range of companies currently complying with Section 404 under the guidance issued for companies and auditors in 2007. In addition to assessing the Section 404 costs resulting from the Commission's recent actions, the findings also will be used to support Commission decisions on improving the efficiency and effectiveness of Section 404 implementation. The staff expects to complete the study by late summer or early fall.

The table below summarizes the proposed implementation dates for non-accelerated filers.

The release is available on the SEC website at: <http://www.sec.gov/rules/proposed/2008/33-8889.pdf>.

## Commission and Staff Guidance

### Commission Guidance Regarding Management's Report on ICFR

(Release 33-8810)

In June, the SEC published interpretive guidance for management on evaluating and assessing internal control over reporting. The guidance became effective upon publication. It provides management with an approach to use in conducting a top-down, risk-based evaluation of ICFR to satisfy management's evaluation requirements under the SEC's rules.

The guidance reiterates the Commission's position that management should bring its own experience and informed judgment to bear in order to design an evaluation process that meets the needs of its company and that provides a reasonable basis for its annual assessment. As a result, management's approach to testing may differ from the auditor's. The guidance also allows management sufficient and appropriate flexibility to design an evaluation process such that in some instances direct testing may be required whereas in other areas, depending on assessed risk, ongoing monitoring activities may be sufficient.

The interpretive guidance is principles-based, and is organized around two broad principles:

- Management should evaluate whether it has implemented controls that adequately address the risk that a material

misstatement of the financial statements would not be prevented or detected in a timely manner; and

- Management's evaluation of evidence about the operation of its controls should be based on its risk assessment.

By applying these two principles, management will be able to tailor its evaluation and assessment of ICFR in a way that reflects its unique operating characteristics and is most efficient.

The guidance recognizes that internal control systems, methods and procedures necessary to evaluate ICFR may be different in smaller public companies than in larger companies, but is not meant to imply that evaluations for smaller public companies be conducted with less rigor or to provide anything less than reasonable assurance as to the effectiveness of ICFR. Rather, smaller public companies are advised to use the flexibility of the guidance to cost-effectively tailor and scale their methods and approaches for identifying, documenting and evaluating their controls.

The release is available on the SEC's website at: <http://www.sec.gov/rules/interp/2007/33-8810.pdf>.

To assist smaller reporting companies with ICFR compliance, the SEC staff released Sarbanes-Oxley Section 404 – a Guide for Small Business. This Plain English short summary of the requirements for management's assessment of and reporting on internal controls is

#### Reporting on ICFR – Implementation Dates for Non-Accelerated Filers

**Management reporting**

**Fiscal years ending on or after December 15, 2007**

**Auditor reporting:**

**Current**

**Fiscal years ending on or after December 15, 2008**

**Proposed**

**Fiscal years ending on or after December 15, 2009**

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available on the SEC's website at <http://www.sec.gov/info/smallbus/404guide.shtml>.

### Executive Compensation Disclosure

Registrants implemented the new executive compensation disclosure rules adopted in 2006 in their 2006 annual reports. In 2007, the SEC staff reviewed the executive compensation disclosures of approximately 350 issuers and issued comment letters on these disclosures. The staff summarized its comments in a report, Staff Observations in the Review of Executive Compensation Disclosure. The report indicated that the biggest shortcoming of the first-year disclosures was missing analysis. Registrants provided large amounts of detail, but often did not provide how and why the described compensation philosophies and processes resulted in the compensation amounts presented in the tabular disclosures. Other examples of where analysis was missing included disclosures with respect to benchmarks, differences in compensation policies and decisions among executive officers, change-in-control arrangements, and performance targets. When registrants did not disclose material performance target information, the staff asked them to disclose the information or explain why the disclosure would cause competitive harm. If the registrant supported that the disclosure would cause competitive harm, the staff asked that it discuss how likely it will be for the company to achieve the target.

The report also observed that registrants should improve the manner in which they present their executive compensation disclosures. The staff reminded registrations to present information that is meaningful and responsive to disclosure

requirements in a clear and understandable manner. The staff suggested that registrants consider the following questions in preparing their disclosures:

- What is material to my shareholders and to my investors, as they examine the compensation of our executives and make their voting decisions for our board of directors and investment decisions with respect to our company?
- What are the material elements of individual executive and corporate performance that are considered in setting executive compensation?
- What is the relationship between the objectives of our compensation program and the different elements of compensation?
- What are the material factors that relate to our compensation decision-making process?

In December, the staff made an Executive Compensation Reader available on its website. With this tool, users can compare executive compensation information for 500 of the largest registrants.

Staff Observations in the Review of Executive Compensation Disclosure is available at: <http://www.sec.gov/divisions/corpfin/guidance/execcompdisclosure.htm>. John White, the Director of the Division of Corporation Finance, summarized the staff's observations in a speech he delivered on October 9, 2007 entitled, "Where's the Analysis?" available at: [http://www.sec.gov/news/speech/2007/spch100907jwu.htm#P26\\_3221](http://www.sec.gov/news/speech/2007/spch100907jwu.htm#P26_3221).

The Executive Compensation Reader is available at: <http://www.sec.gov/xbrl>.

### SAB No. 109 – Written Loan Commitments

In November, the SEC staff expressed its views regarding the accounting for written loan commitments that are accounted for at fair value through earnings in SAB No. 109 (SAB Topic 5DD), *Written Loan Commitments Recorded at Fair Value through Earnings*. The SAB revises and supersedes the staff's prior views, which were expressed in SAB No. 105 (SAB Topic 5DD), *Application of Accounting Principles to Loan Commitments*. The SAB affects the accounting for registrants in the financial services industry and other companies that engage in certain lending activities. SAB 109 does not affect the accounting for holders of loan commitments (that is, the prospective borrowers). SAB 109 is effective prospectively for derivative loan commitments issued or modified in fiscal quarters beginning after December 15, 2007.

Under current accounting rules, a written loan commitment is accounted for at fair value (and therefore subject to the provisions of the SAB) if the written loan commitment (a) relates to the origination of mortgage loans that the entity intends to sell and is accounted for as a derivative under FASB Statement No. 133, *Accounting for Derivatives and Hedging Activities*, or (b) is not a derivative but is accounted for at fair value under FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*.

Under SAB 109, expected cash flows related to servicing the loan should be included in the measurement of all written loan commitments that are accounted for at fair value. Servicing cash flows include servicing fees (included in the loan's interest rate or otherwise), late charges and other fees,

and proceeds received from selling the servicing rights to a third party. The staff previously believed that such servicing cash flows should not be included in the fair value measurement of a written loan commitment.

The SAB retains the guidance from SAB 105 that internally-developed intangible assets (such as customer relationship intangibles) should not be recorded as part of the fair value of a written loan commitment accounted for as a derivative. This guidance was expanded to apply to all written loan commitments accounted for at fair value.

SAB 109 is available on the SEC's website at: [www.sec.gov/interps/account/sab109.htm](http://www.sec.gov/interps/account/sab109.htm).

## SAB No. 110 – Share-Based Payment

In December, the SEC staff allowed registrants to continue to use the “simplified method” defined in SAB No. 107, *Share-Based Payment*, (SAB Topic 14) for determining the expected term of “plain vanilla” options. Under FASB Statement No. 123R, *Share-Based Payment*, expected term is one of the primary factors used to measure fair value of share option grants. In SAB 107, the staff stated that it would not expect registrants to use the simplified method for share option grants after December 31, 2007. SAB 110 removes the end date for using the simplified method but establishes conditions for its use. The SAB is effective January 1, 2008.

In SAB 107, the staff indicated that use of the simplified method would not be necessary after December 31, 2007 as it expected registrants to have more detailed external information about employee exercise behavior for share

option grants by that time. In SAB 110, the staff observed that such information *might* not be widely available, and, therefore, under certain circumstances, it will allow continued use of the simplified method for plain vanilla options. Plain vanilla options are defined in SAB 107 as options that are granted at-the-money, exercisable only if service is performed through the vesting date, forfeited if the employee terminates prior to vesting, exercisable in a limited time frame if the employee terminates after vesting, and nontransferable and nonhedgeable. Under the simplified method, expected term is equal to the midpoint between the vesting date and the expiration date of the option.

Under SAB 110, registrants can use the simplified method if they conclude that their stock option exercise experience does not provide a reasonable basis upon which to estimate expected term. Once registrants have sufficient historical share option exercise experience upon which to estimate expected term, the simplified method may no longer be used. The staff provided the following examples of when use of the simplified method is appropriate because the registrant's historical exercise data may not provide a reasonable basis to estimate expected term:

- The registrant's equity shares have been publicly traded for only a limited time.
- The registrant significantly changes the terms of its share option grants or the types of employees that receive share option grants.
- The registrant has or expects to have significant structural changes in its business.

In SAB 110, the staff indicated that it will allow registrants to use the simplified method for those share options for

which it does not have a reasonable basis to estimate expected term while using historical exercise data for the remainder of the grants. Also, the staff observed that it will not object to the use of the simplified method in the periods before a company's equity shares are publicly traded.

Registrants using the simplified method are required to disclose:

- The use of the method;
- The reason why the method is used;
- The types of share option grants for which the method was used if the method was not used for all share option grants; and
- The periods for which the method was used if the method was not used for all periods.

SAB 110 is available on the SEC's website at: [www.sec.gov/interps/account/sab110.htm](http://www.sec.gov/interps/account/sab110.htm).

## XBRL

The SEC continued to promote the use and efficacy of XBRL in 2007 and created the new Office of Interactive Data to support this effort. XBRL is a reporting language used to tag data based on taxonomies (a set of accounting definitions) that categorize financial statement information. In December, the SEC announced XBRL U.S.'s release of an expanded taxonomy for U.S. GAAP that is available for user feedback at <http://usgaap.xbrl.us>. The SEC staff's next step in the XBRL project plan is to evaluate XBRL U.S. and user feedback on the expanded taxonomy. The staff expects to consider proposing rules to require XBRL reporting, and is evaluating the following issues:

## Financial Reporting

- Should XBRL reporting be required for just the financial statements or for both the financial statements and the footnotes?
- Should XBRL reporting be mandated for all registrants as of a certain date or should it be phased in?
- Should auditor reporting on data tagging be required?
- Should the XBRL reports be due with the filing or at a later date?
- Should the XBRL reports be furnished or filed?

Also, U.S. GAAP and IFRS XBRL taxonomy teams are working to ensure that the two taxonomies are aligned.

For more information, see our publication, *XBRL: What Should Companies Do Now?* available at: <http://www.bdo.com/services/assurance/documents/Clientadvisory-2007-1.pdf>.

## PCAOB Developments

### Standards

#### Auditing Standard No. 5

AS 5 was approved by the SEC in July, 2007 and is effective for audits of fiscal years ending on or after November 15, 2007. AS 5 is a principles-based standard that is designed to allow auditors to exercise professional judgment in focusing effort on those areas that present the greatest risk of a material misstatement occurring in the financial statements, and in reducing testing in those areas of lowest risk. Further, the standard eliminates audit requirements that were considered unnecessary to achieve the intended benefits. The standard also provides direction on how to scale the audit for a smaller and/or less complex company or portions thereof.

The highlights of AS 5 are as follows:

*Top-down approach* – The standard emphasizes this approach, which was referred to in the PCAOB’s May 2005 guidance. AS 5 goes further, in that it allows the auditor to determine that entity level controls may be sufficient to address the risk of misstatement related to a particular relevant assertion when such entity level controls operate at a sufficient level of precision.

*Large portion requirement* – AS 5 removed the requirement to test a “large portion” based on a “coverage” concept, and instead incorporates a risk-based assessment of locations and/or financial statement areas to test.

*Risk assessment* – AS 5 emphasizes the auditor’s assessment of risk and the use of risk assessment in the selection of controls to test. As a result, there is an expanded discussion of the relationship of risk to the evidence necessary to conclude that a given control is effective. Further, there is expanded guidance on the auditor’s assessment of the risk of fraud, including identification and testing of controls to address the risk of material misstatement due to fraud and due to management override.

*Integration with the financial statement audit* – The standard directs the auditor to consider the results of substantive audit procedures performed in the financial statement audit when determining the overall risk related to a control. However, controls must be directly tested and effectiveness cannot be inferred solely from the absence of misstatements detected by the auditor in the substantive testing relative to the financial statement audit.

*Revision of certain definitions* – The definitions of “material weakness” and “sig-

nificant deficiency” were revised as discussed above and are consistent with those included within the SEC’s rules.

*Clarification of the role of materiality, including interim materiality* – AS 5 clarified that the same materiality is used for assessing ICFR and financial statements and that the role of interim materiality is relevant only to the evaluation of deficiencies and not to determining the scope of the engagement.

*Elimination of the requirement to report on management’s assessment and evaluate management’s process* – The auditor is required to obtain an understanding of management’s process as a starting point to understanding the company’s internal control, assessing risk, and determining the extent to which the work of others may be used, but is no longer required to opine on management’s assessment.

*Flexibility to reduce testing* – AS 5 removed the phrase, “each year’s audit must stand on its own.” However, while the standard allows the auditor to vary the nature, timing and extent of testing, it does not to permit “rotation” as the term is commonly used.

*Using the work of others* – The standard encourages auditors to use the work of others when that work is of high quality and performed by competent and objective client personnel. However, the extent to which the auditor may use the work of others also depends on the risk associated with the control being tested. As the risk increases, the need for the auditor to perform his or her own work increases. In this regard the PCAOB eliminated the “principal evidence” provision from AS 2 which may have restricted the use of the work of others in some respects, and also omitted the

specific restriction present in AS 2 regarding using the work of others in the assessment of the control environment.

*Performing walkthroughs* – AS 5 emphasizes the requirement to obtain an understanding of the likely sources of potential material misstatements in determining which controls to test, rather than prescribing the process by which this understanding is obtained. Therefore, AS 5 does not require walkthroughs, but states that walkthroughs will frequently be the most effective way of achieving some of the specific objectives of the standard. The standard states that due to the degree of judgment involved in achieving the objectives referred to above, these procedures would ordinarily be performed by the auditor, but permits auditors to supervise the work of others who may provide direct assistance in this regard.

*Scalability* – AS 5 provides scalability considerations for entities of varying sizes and complexities. The standard recognizes that even large complex companies may have non-complex components and as a result this concept applies to all entities.

AS 5 is available on the PCAOB website at: [http://www.pcaob.us.org/Rules/Docket\\_021/2007-05-24\\_Release\\_No\\_2007-005.pdf](http://www.pcaob.us.org/Rules/Docket_021/2007-05-24_Release_No_2007-005.pdf).

## Guidance

### **Audit Practice Alert – Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists**

In December, the PCAOB issued Staff Audit Practice Alert No. 2, which reminds auditors of their responsibilities when auditing fair value measurements

and using the work of specialists. The practice alert does not provide new auditing guidance, but describes the applicable auditing requirements in these areas. This alert is organized into four sections:

- Auditing fair value measurements;
- Classification within the fair value hierarchy under FASB Statement No. 157;
- Using the work of specialists; and
- Use of a pricing service.

*The alert is available on the PCAOB website at: [http://www.pcaob.org/Standards/Staff\\_Questions\\_and\\_Answers/2007/12-10\\_APA\\_2.pdf](http://www.pcaob.org/Standards/Staff_Questions_and_Answers/2007/12-10_APA_2.pdf).*

### **FAQ – Ethics and Independence Rules**

In April, the PCAOB staff issued a frequently asked questions document, Staff Questions and Answers – Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees, that provides further interpretation of the auditor independence and tax services rules that became effective in April 2006. This document discusses six issues regarding auditor independence and tax transactions, such as the auditor's role in tax planning engagements and the auditor's involvement in tax planning alternatives.

The staff FAQ is available on the PCAOB website at: [http://www.pcaob.org/Standards/Staff\\_Questions\\_and\\_Answers/2007/Tax\\_Services.pdf](http://www.pcaob.org/Standards/Staff_Questions_and_Answers/2007/Tax_Services.pdf).

## Committees

### **SEC Advisory Committee on Improvements to Financial Reporting**

The SEC established its Advisory Committee on Improvements to Financial Reporting, known as CIFI<sup>R</sup> or the Pozen Committee, in 2007. The Commission has charged this Committee with examining the U.S. financial reporting system to identify ways to reduce unnecessary complexity and make financial statements and financial information more useful and understandable to investors. CIFI<sup>R</sup> has identified five areas of complexity and established the following five subcommittees to develop recommendations:

- Substantive Complexity
- Standard Setting Process
- Audit Process and Compliance
- Delivering Financial Information
- International Coordination

In January 2008, CIFI<sup>R</sup> met to discuss its preliminary recommendations. The recommendations will be discussed further at meetings in February and March.

CIFI<sup>R</sup> expects to begin issuing recommendations in the spring and complete its work in the summer of 2008.

CIFI<sup>R</sup>'s reports and certain webcasts are available on the SEC's website at: <http://www.sec.gov/about/offices/local/acifr.shtml>.

### **Treasury Department's Advisory Committee on the Auditing Profession**

The Treasury Department's Advisory Committee on the Auditing Profession, known as the Paulson Committee, was

## Financial Reporting

established in 2007 to develop recommendations to address the sustainability of a strong and vibrant auditing profession. The Committee is chaired by Arthur Levitt (former SEC Chairman) and Don Nicolaisen (former SEC Chief Accountant). The Committee has formed three subcommittees to address:

- Human capital and its impact on audit quality;
- The audit firm and the audit: audit firm organization (structure, governance, and transparency); financial resources (insurability and liability) and communication; and
- Structural changes in the profession (competition, concentration, independence, and other professional standards).

The Committee met in October and December, and has a meeting scheduled for February 2008. The Committee expects to produce findings and recom-

mendations by early summer 2008. More information is available at: <http://www.treas.gov/offices/domestic-finance/acap>.

## For Further Information

If you would like to discuss the content of this Financial Reporting and the impact it may have on your business, please call:

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