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AICPA Conference on SEC and PCAOB Developments

Companies and auditors face fast-paced changes in accounting and reporting, according to speakers at the recent AICPA conference on SEC and PCAOB developments, who identified challenges, initiatives, and goals that would serve the long-term interests of the financial-reporting community. They emphasized the need to simplify accounting standards, converge U.S. GAAP and international accounting standards, and move domestic companies to XBRL and IFRS reporting in SEC filings. They also explored the role of materiality and professional judgment.

The speakers included representatives of the SEC, the FASB, the IASB, and the PCAOB.

Complexity in Financial Reporting

The need to reduce the complexity of financial accounting and reporting was a consistent theme throughout the conference. Coming up with recommendations to help solve this problem is a key aim of the SEC Advisory Committee on Improvements to Financial Reporting, chaired by Robert C. Pozen. He explained at the conference that the committee is focusing on five areas—the causes and effects of complexity in accounting and reporting standards, the standard-setting process, the process of regulating company and auditor compliance, financial-information delivery, and international coordination.

Mr. Pozen cited several factors that introduce complexity into financial reporting, including “quasi-GAAP,” such as industry-specific guidance and SEC staff guidance and enforcement cases; companies’ desires to suppress volatility in financial statements; and the varying needs of investors. He also held that the frequency of restatements in recent years contributed to complexity by confusing investors and causing an information vacuum during the restatement process.

The Advisory Committee’s activities include or will include:

- Reviewing the SEC’s guidance on materiality in the context of the current needs of investors, partly because materiality has been a significant factor in the number of restatements. The committee will examine whether SAB 99 reflects the concept of materiality from the perspective of investors.¹

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¹ SEC Staff Accounting Bulletin No. 99, Materiality, available at www.sec.gov.

- Considering whether new accounting standards should include an implementation period during which preparers, the standard setter, regulators, and auditors would identify implementation issues, after which the standard setter would reassesses the standard in light of the issues identified.
- Closely following the FASB's financial statement-presentation project. The committee supports distinguishing between "core" earnings and other "unrealized" items, because it may alleviate concerns associated with income-statement volatility unrelated to core earnings.
- Addressing some of the practical steps that will be necessary to move toward international convergence, including IASB governance and the SEC's oversight role. Mr. Pozen expressed concern that providing U.S. companies with an option to choose between IFRS and U.S. GAAP would add complexity to financial reporting.

The Committee's recommendations are now scheduled to be submitted to the SEC no later than August 2008, with some recommendations expected earlier.

A Global Financial Reporting System

The general consensus was that the United States will be transitioning to IFRS, but how and when to get there must be worked out. Globalization of the financial reporting system as a whole is a "threshold issue for the U.S. reporting system," according to FASB Chairman Robert H. Herz. He distinguished between converging accounting standards and the ultimate goal of a high quality global financial-reporting system. Such a system would encompass the application

and interpretation of standards, MD&A-type disclosures, auditing standards and practices, regulatory review, college and university education, subsequent training, financial-information delivery mechanisms, such as XBRL, and corporate governance.

Speakers from the SEC cited its support for a single set of global high quality accounting standards. Commissioner Kathleen L. Casey referred to the recent decision to eliminate the reconciliation requirement for foreign private issuers that prepare financial statements in accordance with IFRS as issued by the IASB, saying it signaled the SEC's support for a single set of high quality accounting standards and confidence in international accounting standards.

Julie Erhardt, Deputy Chief Accountant, cited evidence that SEC constituents support the goal of moving to IFRS in the U.S., noting that responses to the Concept Release on allowing U.S. companies to file IFRS financial statements were supportive.² However, she also pointed out that users and preparers differ in their readiness for the transition, making strategies for potential conversion to IFRS by all public companies difficult to devise.

The transition options Ms. Erhardt cited were to require all companies to convert at the same time, to permit companies ready to convert to IFRS to do so, or some combination. The first alternative would maintain comparability among U.S. registrants. The second would permit some registrants to obtain the benefits of global comparability more quickly.

Convergence Efforts. Board members from the FASB and IASB updated conference attendees on joint projects, including the conceptual framework, liabilities and equity,

and financial-statement presentation. Other key projects include revenue recognition and leases. The conceptual framework is important, Board members held, both because of its potential help in ensuring that the standard-setting process is neutral and because of its help in developing principles-based standards. An effective conceptual framework was also recognized as essential to help preparers resolve complex accounting problems not explicitly addressed in the standards.

PCAOB Chairman Mark W. Olson and other representatives from the PCAOB said that global markets and the focus on a global set of accounting standards will help lead to global auditing standards. They pointed out that convergence would be a consideration in the PCAOB's future activities. But they also noted that differences would remain between PCAOB and international standards because of the different auditing environment in the U.S.

The PCAOB recently issued for public comment a policy statement on enhancing cross-border cooperation with its peer organizations around the world.³ The policy statement's approach would enable the PCAOB to move beyond joint inspections toward full reliance on oversight bodies in other countries that meet specified criteria. The comment period closes on March 4, 2008, and Mr. Olson encouraged interested parties to provide comments.

Internal Control Reporting

Representatives of the SEC and the PCAOB emphasized that the SEC's interpretive guidance for management and Auditing Standard No. 5 are designed to help alleviate the burden of Section 404 reporting through greater effectiveness and efficiency.⁴

² SEC Release No. 33-8831, Concept Release On Allowing U.S. Issuers To Prepare Financial Statements In Accordance With International Financial Reporting Standards, August 7, 2007, available at www.sec.gov.

³ The proposed policy statement, "Guidance Regarding Implementation of PCAOB Rule 4012," http://www.pcaobus.org/Inspections/Other/2007/12-05_Release_2007-011.pdf.

⁴ SEC Releases No. 33-8810, Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, June 20, 2007, available at www.sec.gov. PCAOB, Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, May 24, 2007, available at www.pcaobus.org.

Commissioner Casey explained that the SEC's objective was to "empower companies and their auditors to exercise judgment in assessing the appropriateness of internal control systems...and to focus on the areas of greatest risk." Speakers gave prominence in their remarks to the "top-down" approach to selecting controls to test and the focus on risk and principles in the interpretive guidance and Auditing Standard No. 5.

Commissioner Casey believes that an assessment of the effectiveness of efforts to reduce larger companies' compliance costs should be completed before setting a timetable for full compliance with Section 404 by smaller public companies.

SEC to Propose Delay of Section 404(b) Audits for Small Companies

Chairman Christopher Cox, in recent Congressional testimony, said that he would propose to the Commission an additional one-year deferral for small businesses of the audit requirements in Section 404(b) of the Sarbanes-Oxley Act. If adopted, the delay would make the requirements applicable to years ending after December 15, 2009.

SEC Staff Views on Management's Evaluation. Speakers from the SEC staff noted that most material-weakness disclosures originate when material errors are discovered in the financial statements. The staff reminded management and auditors that a material weakness can exist in the absence of a material financial-statement error.

In determining the root cause of financial-statement errors, companies need to consider whether risk assessment, monitoring, and other entity-level controls are designed to effectively identify control breakdowns in a timely manner, and how those programs help in identifying and evaluating changes

in internal control over financial reporting for purposes of making quarterly certifications. These considerations will help management determine if its internal control system is designed to provide it with timely information about control weaknesses and if not, why this fact does not represent a material weakness that should be disclosed to investors.

The staff reminded companies that multiple material weaknesses may indicate more pervasive problems that should be disclosed, such as weaknesses in entity-level risk assessment and monitoring.

The staff may request information from companies in order to understand how they evaluated deficiencies that were not considered material weaknesses.

The staff analyzed the relevant considerations in applying Section 404 implementation relief to newly public companies that become public through reverse mergers or through the use of special acquisition companies. They also gave their views on applying previous SEC staff guidance when newly acquired companies are excluded from management's evaluation in the year acquired.

Implications of the Credit Environment

The SEC staff underscored the effect of current illiquid credit-market conditions on disclosure obligations. They reminded registrants that MD&A is the best place to disclose information about the most judgmental and difficult areas in financial reporting and that the minimum U.S. GAAP disclosures may not be adequate for investors to evaluate how the illiquid conditions will affect a company's performance. Staff presentations gave extensive examples of desirable types of disclosures from registrants whose off-balance-sheet arrangements have or are reasonably likely to have current or future effects on liquidity, results of operations, financial condition or change in financial condition, revenues or expenses, or capital

expenditures and resources.

The PCAOB staff has developed an Audit Practice Alert to assist auditors in responding to challenges presented by the subprime credit situation, as well as certain issues that might arise in the transition to Statement 157.⁵

SEC Staff Views on Emerging Accounting Issues

The SEC staff made presentations on several technical accounting matters. The staff pointed out that they did not intend to create new guidance, but to describe how they believe existing accounting and disclosure requirements should be applied. The presentation topics included revenue recognition, litigation settlements with multiple-element considerations, financial-asset classification and other-than-temporary impairment, application of the fair-value option when non-financial performance obligations exist, business combinations accounting, and share-based-payment valuations when using market instruments, the simplified method of calculating expected term, and transferability restrictions.

Professional Judgment

Jim Kroeker, Deputy Chief Accountant, explained steps a company can take to have increased confidence in accounting conclusions. The company should obtain a complete understanding of the transaction or event, including the rights and obligations of each party, solicit unbiased input from other knowledgeable and experienced individuals, be aware that there might not always be one "right" answer, and provide informative disclosure. SEC staff members said they were willing to accept reasonable judgments, but emphasized the importance of disclosure that enables investors to understand the unique facts and circumstances supporting management's judgments in significant areas. They explained that concerns about management's

⁵ PCAOB Staff Audit Practice Alert, Matters Relating to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists, December 2007, available at www.pcaobus.org. FASB Statement No. 157, Fair Value Measurements, September 2006, available at www.fasb.org.

judgments generally arise when disclosures are unclear or counterintuitive, accounting judgments are contradicted by the disclosure, or the judgment is based on superseded accounting guidance.

Restatements and Materiality

Several speakers referred to the effect of restatements in recent years on confidence in our capital markets. Wayne Carnall, the newly appointed Chief Accountant of the Division of Corporation Finance, suggested that the large number of restatements diminished the attractiveness of the U.S. capital markets, causing at least part of the movement to private equity and reducing the number of foreign private issuers.

Several speakers attributed the high number of restatements in part to the

current interpretation of materiality. They pointed to the many restatements filed for “technical corrections” that do not appear to be of importance to investors. One staff member explained that restatements caused in this way might be reduced if materiality is considered from the perspective of a “reasonable investor.”

XBRL

Many speakers at the conference pointed out potential benefits from using XBRL in SEC filings, noting the recent release of draft U.S. GAAP taxonomies for public review and comment.⁶ XBRL is a computer language that can be used to create and deliver financial information that is easily searchable and retrievable and therefore facilitates investors’ and preparers’ analyses of companies of any size and complexity.

The SEC staff encouraged participation in the Commission’s voluntary program to submit financial information in XBRL.

The staff noted that an XBRL Preparer’s Guide is available from XBRL US. It provides practical guidance on how to “tag” a set of financial statements. Tagging applies the coded identifiers that enable recipients of an XBRL report to use their own analytical or processing software to interpret the reported information. The SEC is currently considering whether filing XBRL financial statements should be mandatory or voluntary, whether such information should be filed or furnished, whether management’s internal-control certification should apply to the tagging, and whether the tagging should be subject to third-party assurance.

For More on the Conference

A comprehensive account of the Conference, with KPMG commentary, is available in KPMG’s Issues In-Depth, available at www.us.kpmg.com/2007AICPAConferenceSEC-PCAOB. The publication includes coverage of SEC staff presentations on the following accounting matters:

- Revenue recognition in multiple-element arrangements including accounting for hardware deliverables in software arrangements, presentation of product and services revenue when separate recognition is not achieved and participation on a joint steering committee in a collaborative research and development arrangement
- Initial adoption of the fair value option and the use of such option when non-financial performance obligations exist
- Issues identified in accounting for business combinations, such as the use of the replacement cost approach in valuing intangible assets and identifying the acquirer when board members representing minority shareholders control the board
- Valuation considerations for share-based compensation arrangements, including discounts arising from transferability restrictions, use of the simplified method of calculating the expected term for share options, and use of market-based instruments to value share-based payments
- The classification of financial assets, specifically loans receivable, and other-than-temporary impairment considerations for financial assets
- Accounting for litigation settlements requiring consideration of whether there are multiple elements in the settlement arrangement that should be accounted for separately
- Accounting for indemnification arrangements in a spin-off
- Derivative financial instruments indexed to and potentially settled in a company’s own stock
- Change in accounting from consolidation to equity method

⁶ XBRL stands for Extensible Business Reporting Language.



The descriptive and summary statements in this newsletter are not intended to be a substitute for the text of any of the cited documents or any other applicable or potential accounting literature or SEC regulations. When complying with GAAP or filing requirements, companies should consult the text of the applicable documents that set out requirements, consider their particular circumstances, and consult their accounting and legal advisors.

**This is a publication of KPMG's
Department of Professional
Practice—Audit
212-909-5600**

Contributing authors:

Michael G. Gaynor
Brian K. Roberson
Tracey Driver

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