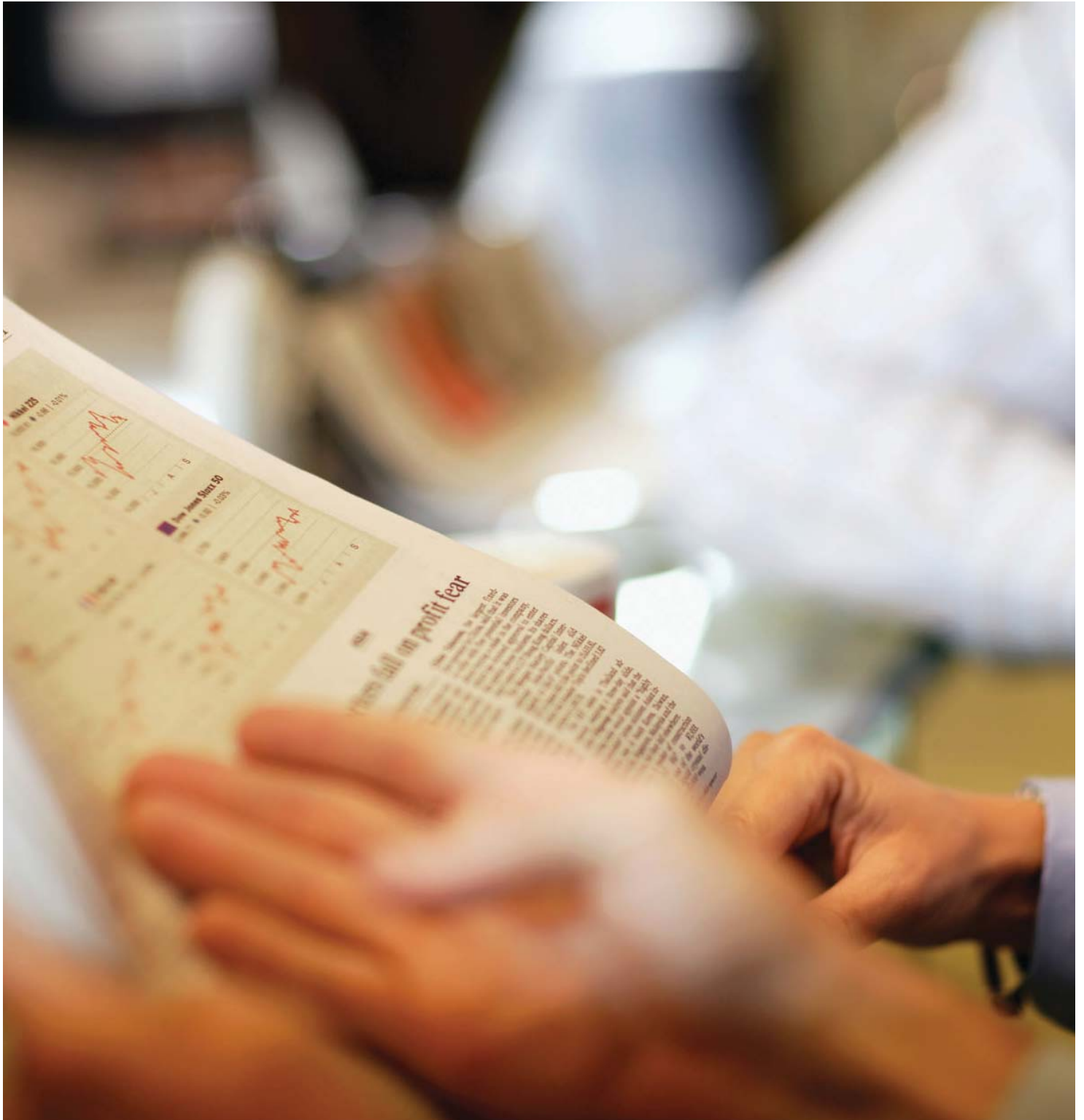


2007

Current developments for directors\*



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## To Our Clients and Friends:

*Current Developments for Directors* looks from your point of view at the key issues facing you as a director. Its purpose is to offer information, insights, and practical guidance so that you can meet the demands of your role more knowledgeably and enrich boardroom discussions.

Three key concerns stand out in 2007 for directors: the call for *transparency* of information delivered to shareholders; the growing pressures on *director accountability* for certain key processes and decisions; and the need to address and satisfy *multiple constituents* inside and outside the company. These issues are not new. They have long been part of the director's job description. But their importance is now much more explicit. New regulations and standards are having an impact on them, and the attention focused on them in the media and elsewhere has increased.

Information transparency and director accountability are closely linked. New SEC regulations require companies to provide significant new financial information and greater transparency around executive compensation. The board's responsibilities include setting the level and kinds of executive compensation. Shareholders, employees, and the media can be expected to closely watch the new executive compensation disclosures and use them to assess how realistically directors are aligning executive pay with performance.

There is a related issue: the stock option backdating investigations and enforcement actions undertaken by the SEC at some companies. The issue is prompting many directors, even at the many companies untouched by the issue, to wonder whether other risks out there simply haven't hit their radar screens—prompting the question, *How do you know what you don't know?* At the end of major sections of this publication, you'll find recommended "Directors' actions"—steps you can take and inquiries you can make to improve your knowledge of key areas.

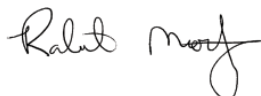
On other fronts as well, there is a focus on information transparency and director accountability. Two new financial reporting standards, offering more transparency to investors, will require companies to provide a clearer picture of the sustainability of their tax positions and to record net liabilities (or assets) for pension benefits on their balance sheets. While the tax issue is technical, it can have bottom-line impact and increases the disclosures companies will make about their tax risks and reserves. The accounting for pension and related benefits has a cascade of implications for company culture, employee morale, and public policy, all areas where the board's advice and oversight are important.

The issue of director accountability also arises with respect to the audit committee's role as the employer of the external auditors. In response to concerns over the cost of 404 internal control reporting, both the SEC and the PCAOB have proposed ways to streamline what management and auditors must do to comply with this much-debated Sarbanes-Oxley requirement. Audit committees will want to understand how management and the external auditors are working together to enhance efficiency in the internal control reporting process.

The third concern, the need for boards to address the views of multiple constituents with differing agendas, could have a personal impact on some directors. In 2007 and soon after, new rules from the SEC may give shareholders direct access to place director nominees on company proxies. That ruling could lead to fundamental changes in director elections and, on occasion, to heightened boardroom contention if advocates of specific, controversial points of view become sitting directors. Here again, the issue is not entirely new, but it is becoming more explicit. As key advisors to management, directors focus on the company and its needs. As overseers on behalf of shareholders, directors focus on the needs of the owners of the business—the shareholders. And as the most central element in the company's governance structure, directors must be knowledgeable about and thoroughly responsive to existing and new regulations and standards. Finding the right balance among these accountabilities is arguably a greater challenge for directors in today's environment of heightened compliance requirements and shareholder activism.

Looking beyond the US market for a moment, it's clear that the increase in the global mobility of capital means that we all have a stake in promoting reliable and transparent markets around the world. This was highlighted in a white paper published by the CEOs of the six largest global accounting firm networks, which we recommend to you. Briefly discussed on page 36 of this publication, it shares a vision of 21st-century capital markets that we think you'll find compelling.

Clearly, the issues facing directors are challenging and complex. They are also engaging on many levels. PricewaterhouseCoopers is committed to helping you understand the issues and meet the demands of your vital role as a director. We would be pleased to discuss the contents of this publication with you and, in whatever ways are helpful, to deliver to you and your board colleagues the full resources and experience of our firm.



Robert E. Moritz  
Americas Leader,  
Assurance and Business Advisory Services



Catherine L. Bromilow  
Partner and US Leader of  
Corporate Governance

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# Executive compensation

The spotlight is on executive compensation, putting compensation committees in the hot seat. Some major shareholders, proxy advisory firms, and the media have voiced their concerns and criticism over what is widely perceived as excessive compensation, pressuring directors to link executive pay more clearly to long-term company performance. And directors share in the concern. According to a 2006 survey conducted by PricewaterhouseCoopers and *Corporate Board Member* magazine, 72% of independent directors believe US company boards are having trouble controlling the amount of CEO compensation.

Investors also want greater transparency over how much executives earn or might earn. Investors have had a difficult time determining total compensation, as past proxy disclosures were lacking in important ways and not easily digestible. The SEC's new disclosure rules are designed to ensure investors get clear and comprehensive disclosures on all forms of compensation. The new disclosures will require substantial preparation and effort, and calendar-year-end companies will have to provide them starting with the 2007 proxy season. The expanded disclosures should give shareholders and directors alike more information for evaluating the appropriateness of senior executive compensation. In fact, they already are triggering changes in compensation policies at some companies, especially for perquisites.

Another key element of compensation—stock options—has been under particular scrutiny. Initially spurred by media reports alleging the backdating of stock option grants, companies have launched internal investigations and there have been inquiries by the SEC, the Department of Justice, and others. More than 200 companies have announced investigations, touching some high-profile, successful executives. A number of executives resigned or were terminated or suspended. And increasingly, companies are reducing or eliminating stock options from their executive and director compensation programs altogether, in favor of other forms of equity such as restricted or performance-based stock grants.

Directors will continue to be under intense scrutiny for their role in setting executive compensation. This means all directors who sit on a board, not just the compensation committee members. So it's helpful for directors to understand the implications of the new SEC disclosure rules.

## Executive compensation disclosure rules—a directors’ perspective

The new SEC rules drive expansive disclosures, which will provide greater transparency around compensation decisions and how they fit into a company’s overall strategy. The most significant provisions impacting directors include:

- Disclosure of total compensation for directors as well as executives
- Changes to the report compensation committees must include in the proxy
- New disclosures about the compensation committee’s processes and procedures
- Expanded related person disclosures

The rules also revise the disclosure of security ownership of officers and directors and require a company to identify its independent directors.

The rules generally become effective for Form 10-K for fiscal years ending on or after December 15, 2006. Appendix A provides additional information on the new disclosures.

### Disclosure of total compensation

For the first time, the 2007 proxy will provide shareholders with the total compensation of the CEO, the CFO, and the three most highly compensated other executives—in one table. The disclosure includes the value of all elements of the executives’ compensation, including stock and option awards, pensions, deferred compensation earnings, tax gross-up payments, and perquisites.

Shareholders will be monitoring these disclosures closely, reacting to total compensation numbers and to amounts in individual columns (such as the wealth accumulated in retirement plans), and comparing compensation levels with those of executives at other companies. If they don’t like what they see, they’ll undoubtedly be vocal. We’ll likely see “withhold vote” campaigns for compensation committee members at some companies. Indeed, some institutional investors are pushing for shareholder resolutions at companies to give shareholders an advisory vote on executive compensation packages, as is done in the UK.

Directors also will have their total compensation disclosed, categorized into the same components as the disclosure for executives. Perquisites like the use of planes, consulting fees, and charitable awards programs, among other items, will be disclosed.

## Revised Compensation Committee Report

The compensation committee will have to provide a new report, stating whether it has reviewed and discussed Compensation Discussion and Analysis (CD&A) with management and, based on its review and discussions, whether it recommended to the full board that CD&A be included in the company's Form 10-K or proxy statement. CD&A is a new narrative disclosure in which management will describe the objectives, policies, and decisions around senior executives' compensation and is described more fully in Appendix A.

## Compensation committee processes and procedures

New disclosures on the compensation committee's processes and procedures for considering and determining executive and director compensation will inform investors about the committee's independence and power. How? By disclosing the scope of the committee's authority and whether any of its members were executives or employees of the company.

Companies also will disclose the identity of any compensation consultants used, whether the compensation committee engaged them directly, the nature and scope of their assignment, and the key instructions they were given. The disclosure will include the role executives played in determining executive and director compensation.

## Expanded disclosure of related person transactions

Related person transactions are generally a sensitive topic. The proxy will disclose which directors are responsible for reviewing and approving related person transactions, as well as the company's policies and procedures for these transactions. The definition of "related persons" now includes stepchildren, stepparents, and cohabitants, as well as persons who were related at any time during the year. And the threshold for disclosure is raised to \$120,000. Directors' role in approving these transactions is a more significant change for NYSE-listed companies, as NASDAQ already requires the audit committee or another independent body of the board of directors to review and approve related person transactions.

## Director independence

The names of directors and director nominees who are independent—based on the independence definition in the applicable listing standards—will be disclosed in the proxy. Additionally, for these individuals, the company will describe any transactions, relationships, or arrangements that the board considered in determining whether a director met independence requirements, but that weren't disclosed in the related person transactions section. The proxy also will disclose any compensation, nominating, and audit committee members who are not independent, highlighting any boards that may not be complying with stock exchange listing standards for independence of key committees.

## Security ownership of officers and directors

Executives, directors, and director nominees will disclose how many shares each owns in the company, as well as the number of shares pledged, to assist investors in understanding how much these individuals have at risk. The disclosure also will identify the number of shares company policy requires directors to hold.

## Reactions

How are directors reacting? According to the 2006 PricewaterhouseCoopers–Corporate Board Member *What Directors Think* survey, conducted in Spring 2006, 88% of directors viewed full disclosure of senior management compensation in the proxy as positive. And 70% said they were not concerned about the new SEC rules.

But as management prepares to implement the rules, directors' concern may have increased. Some companies have announced changes to executive compensation elements—revising executives' change-in-control agreements or changing perquisites. And, as the extensive information on executive compensation becomes publicly available and easily comparable, investors may question arrangements they consider out of line, pressing for changes in executive pay.

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## Directors' actions

- Assess the total compensation disclosed for senior executives and directors, understanding which elements may draw shareholder criticism, and determine whether policy changes are warranted
- Be comfortable that CD&A tells a consistent story with MD&A—Management's Discussion and Analysis
- Assess the compensation committee's charter, processes, and procedures, focusing on the committee's role and authority in compensation decisions, whether it gets the information it needs, and how it interacts with the rest of the board and the other board committees; amend practices if necessary
- Discuss with management the company's policies and procedures for related person transactions, and determine the board's approach for applying such policies and procedures

## Stock option backdating

Many boards are dealing with the ramifications of companies' stock option granting practices, including backdating—selecting an earlier grant date when the stock's market value was lower. At the time of this writing, more than 200 companies have announced internal investigations, and the SEC is reported to be investigating more than 100 companies concerning possibly fraudulent practices.

If a company used an incorrect grant date, it may have to record additional compensation costs in the financial statements, potentially causing a restatement—and possibly leading to inquiries by regulators. In addition, there may be internal control deficiencies and implications for Section 404 internal control assessments for prior periods.

Another important consideration in backdating relates to personnel. If backdating is found to have been fraudulent, the integrity of the executives responsible may be called into question. Since management certifies as to the fair presentation of the financial statements, this could expose executives to a wide range of sanctions, from civil to possibly criminal penalties. There also can be tax consequences to the company and its employees if it did not appropriately identify grant dates.

More recently, the SEC has started to look at the manipulation of exercise dates. In particular, the SEC is examining whether there is evidence that executives adjusted the exercise dates of their options in an effort to reduce their personal tax liabilities. While this isn't thought to be as prevalent as grant date backdating, it nevertheless may have repercussions for some companies and executives.

Looking forward, the consequences described above highlight the importance of a robust process over the granting and pricing of stock options. This process should include both management's detailed policies and procedures and the appropriate level of oversight by the board generally and its compensation committee specifically.

Following are some recommended practices for the granting and pricing of stock options that directors should look for:

- Establish transparent and clearly defined stock option practices
- Document formal policies that clearly define the company's practices and the respective responsibilities of those involved
- Formalize guidelines relating to the size, pricing, and vesting schedule for grants
- Properly and contemporaneously document the actions of the compensation committee
- Establish and maintain appropriate controls to identify and record all reportable transactions
- File on a timely basis SEC disclosure documents, including Form 4 and Form 8-K

## Backdating, springloading, and bullet-dodging—some background

During 2006, numerous media reports discussed potential issues regarding the timing of stock option grants, focusing primarily on the practice of backdating.

The majority of the alleged grant date issues relate to options granted before the passage of the Sarbanes-Oxley Act in 2002, which requires the reporting of option grants within two days. Prior to 2002, companies publicly reported option grants 45 days after the close of the fiscal year during which they granted the options. Many of the companies under investigation had multiple grant dates each year, issued a large volume of options, and had volatile stock prices.

Depending on the period when the option vests, backdating may allow the person receiving the grant to realize increased gains. Also, under the provisions of APB 25, the predecessor accounting rule to FAS 123(R), while stock options granted “at the money” did not require a company to record compensation

expense in the financial statements, options “in the money” at the time of grant should have generated compensation expense.

“Springloading” and “bullet-dodging” are option granting practices related to backdating and likewise have generated media attention. Springloading commonly is defined as a company’s purposefully scheduling an option grant before publicly disclosing good news. Bullet-dodging is purposefully postponing an option grant until after bad news reaches the market, when the stock price has declined. The propriety of these techniques is generating a fair amount of debate in legal circles, and some investors have expressed concerns about their use. The information called for by the new SEC executive compensation disclosure rules—for example, requiring companies to provide more straightforward explanations of their rationale for compensation decisions, as discussed earlier in this section, and expanded disclosure about grant dates—may address this issue.

# Empowering shareholders

In the past, if shareholders were unhappy with the state of governance at a company, there wasn't much they could do—beyond selling their investment—given they had little true influence over something as basic as who was representing them in the boardroom.

That's changing. Shareholders want a greater say in the directors who serve the companies in which they invest. And companies, the courts, and regulators are responding, in ways that may have touched your board already.

- Through the growing use of majority voting and similar models, which give shareholders a greater voice in director elections
- Through rules being considered that would make it easier for shareholders to put alternative director nominees on the company ballot
- Through proposed changes to broker voting from the New York Stock Exchange (NYSE) that would not allow brokers to vote client shares without instructions from clients

Additionally, the SEC and NYSE are allowing companies to provide shareholders proxy and financial information through the Internet—making it more timely and easily accessible, and making it easier for parties outside the company to mount a proxy contest.

The message is clear: The landscape is changing and boards cannot turn a deaf ear to shareholders. While shareholders once may not have had the ability to change things if they were unhappy about how companies were run, today they have more ways to ensure their concerns are addressed—with consequences for directors' reputations. And, as mentioned under Executive Compensation, the new proxy disclosures could drive shareholders to demand change in the boardroom. If dissident directors increasingly are elected to boards, all directors will need to figure out how to work collaboratively to create long-term shareholder value.

## Director elections

Generally, director elections use plurality voting. So, if shareholders are unhappy with a director and most withhold their votes, the director still is reelected as long as there are no opposition candidates.

Shareholders have been asking for a more meaningful voice in electing directors, preferably through companies' adopting majority voting or similar policies. Under majority voting, a director nominee must receive a majority of "for" votes in order to be elected. This policy makes it easier for shareholders to remove directors they're unhappy with. However, it may deter well-qualified candidates from agreeing to be nominated for a board seat if they're concerned about the impact of a "withhold vote" campaign on their personal reputations.

Support is strong for majority voting provisions. Many institutional investors and governance organizations have embraced the majority vote initiative. In fact, majority voting or a similar policy is already in place at more than 200 companies, and many more companies are expected to adopt one in 2007.

While majority voting sounds sensible—it's hard to argue that shareholders shouldn't have a say on which directors represent them—if applied strictly it could have unintended consequences, such as resulting in a board where only a minority of directors are independent. Thus, a modified majority vote policy may be more palatable. This would require a director who doesn't receive a majority of "for" votes to submit his or her resignation to the board, so the board can then decide whether to accept it or not. This gives the board flexibility to ensure it retains the directors it needs, including those with such skills as financial expertise.

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### Directors' action

- Understand the company's current voting policies and, if shareholders are lobbying for different policies, whether a policy change is needed

## Proxy access

If we think of majority voting as giving shareholders a greater say on whom they don't want on a board, proxy access would give them greater say in naming whom they do want to nominate. Currently, shareholders who are dissatisfied with company leadership have to undertake a costly proxy contest to put nominees before the shareholders for a vote. The expense and inherent difficulties of such contests make them relatively rare.

Allowing shareholders to propose directors in a company's proxy materials is hardly a new topic. In 2003 and 2004, the SEC proposed rules that would have allowed long-term, significant shareholders to place director nominees on a company's proxy. Those rules generated a great deal of opposition and were not finalized. But the SEC did provide rules increasing the transparency around companies' nomination processes, including how, if at all, shareholders can recommend director candidates to the nomination committee.<sup>1</sup>

Proxy access resurfaced in 2006. One large institutional investor submitted a proposal that would have amended a company's bylaws to allow for shareholder-nominated candidates in director elections. The SEC did not require the company to include that proposal in its proxy. The investor sued the company. An appeals court ruled for the investor, finding that the SEC's position was not consistent with its earliest interpretations of its proxy rules. In response, the SEC announced that, for the sake of clarity and consistency, it would amend its rules concerning director nominations by shareholders.

The SEC originally was scheduled to expose those proposed rules in October 2006, but deferred the discussion to its December 2006 meeting, when the topic again was removed from the agenda. The complex

and political nature of the proxy access issue may have contributed to the difficulty of crafting a rule that key stakeholders will find palatable. In this highly complicated issue, proponents of proxy access suggest that having greater shareholder input on the selection of directors who will look out for their best interests is fundamental. Opponents are concerned it could result in cluttered ballots and polarized boards, and may increase the influence of single- or special-interest groups.

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### Directors' actions

- Make sure you're aware of SEC developments as rules on proxy access are proposed
- Understand what issues shareholders are particularly concerned about regarding your board or your company's operations
- Be alert for signs of inappropriate tone in management's dealings with shareholders

### A cautionary tale about boardroom dissension

In 2006, Hewlett Packard provided some insight into the damage that can result when there is serious dissension in the boardroom. And while that specific set of facts and circumstances—and their fallout—was unique, current trends indicate there may be a great deal more dissension in more boardrooms. Why? Because it's becoming likelier that unhappy shareholders are going to have greater powers to place directors on boards. With the possibility of divided boardrooms growing, directors will need to find a way to work together to build long-term shareholder value, even when they have divergent points of view.

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<sup>1</sup>For a description of these rules, see *Current Developments for Audit Committees 2004*, available at [www.pwc.com/uscorporategovernance](http://www.pwc.com/uscorporategovernance).

## Broker voting

In October 2006, the NYSE proposed eliminating the current practice of allowing brokers discretionary voting of client shares without instructions from clients. Such discretionary voting applies to matters considered “routine,” which includes uncontested director elections.

If the proposed rule is approved, it would increase the weight of shareholder votes in director elections by reducing brokers’ influence, since typically brokers automatically vote for the company’s nominees. In addition, the proposal likely would reduce the overall number of votes cast, so withhold votes against a director would constitute a greater percentage of total votes cast. This is another element that will give shareholders a greater voice on ballot issues, possibly making it harder for company nominees to get elected. It also points to the need for companies to engage with their shareholders, possibly revamp their investor relations efforts, and encourage shareholders to vote.

If approved, the NYSE rule change generally would take effect for shareholder meetings held on or after January 1, 2008.

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### Directors’ action

- Understand the status of the proposed NYSE discretionary voting rule and discuss with management and investor relations the communication plan to encourage shareholders to provide voting instructions to brokers

## Increased use of technology

To facilitate shareholder involvement in the proxy process, regulators increasingly are relying on technology to make it easier for investors to access information about companies. Two key initiatives in this area are e-proxies and electronic delivery of annual reports.

In December 2006, the SEC approved a rule allowing companies to provide their proxy materials (including annual reports) to shareholders by making them available on the Internet. Companies choosing electronic distribution must deliver a paper notice to shareholders directing them to a website where the proxy materials can be found, as well as contact information for requesting a hard copy. This delivery method—referred to as the “notice and access” model—shifts the default delivery from paper to the Internet. The rule takes effect July 1, 2007. And while companies benefit from easier delivery, so do other parties who want to solicit shareholders, in a proxy contest, say.

An NYSE rule change in August 2006 allows companies to deliver their annual reports by providing an electronic link through the company website—rather than printing and mailing thousands of copies.

These two changes are positive. They give shareholders immediate access to financial information and greater search capabilities, while providing cost savings for companies and ultimately shareholders.

# Financial reporting developments

Investors need the right information to make informed decisions—information that’s reliable, presented clearly, and tells the whole story. For their part, standard setters continue to drive transparent reporting. Two significant new accounting standards on pensions and uncertain tax positions do just that. New rules on pensions require companies to record on the balance sheet a net liability or asset for their postretirement benefits—a change that could result in a company recording a negative net worth. New accounting for uncertain tax positions will provide a clearer picture of the sustainability of a company’s tax positions and could result in income statement volatility.

New guidance also was issued on how to measure the fair value of assets and liabilities to promote greater use of fair value measures in financial reporting. And, with restatements of financial statements on the rise, audit committee members in particular should be aware there is a new approach for quantifying financial statement errors, increasing concern that immaterial errors, if not recorded in the financial statements, could become material in the future.

While all directors will see the impact of these changes in the financial statements, audit committees will want to understand how the new standards and rules, described more fully below, affect the financial statements they’ll be reviewing.

## Postretirement benefits, including pensions

Pensions have been in the spotlight for years, especially given the many US companies with massive unfunded pension liabilities—estimated at \$535 billion.<sup>2</sup> Some major companies have turned over billions of dollars in pension liabilities to the Pension Benefit Guaranty Corporation while in bankruptcy proceedings. Companies, both large and small, are freezing or discontinuing defined benefit pension plans, and rewriting their defined contribution benefit plans. From 1985 to 2000, the number of single-employer defined benefit plans decreased 76%. Meanwhile the number of single-employer defined contribution plans increased by 52%. The predominant driving force behind these changes is substantial, long-term cost savings and more predictable cash flows for US companies that face global competition. Often non-US rivals do not have comparable legacy obligations to their employees.

FAS 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, along with the Pension Protection Act of 2006, will raise the visibility of a company's pension and other postretirement benefit obligations. The objective is to improve the understandability and transparency of benefit amounts reported on companies' balance sheets.

The key provision of FAS 158 requires companies to record the funded status of their defined benefit pension and other postretirement benefit plans by recognizing a net liability or asset on their balance sheets. This is a significant change in balance sheet presentation, as previously unrecorded liability amounts will now be recorded. And, if it drives companies to record negative net worth, that, in turn, could cause some companies to be in default of financial covenants.

Most public companies adopted these new pension recognition and disclosure provisions as of December 31, 2006.

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are now considering all elements of benefit

accounting—a project expected to take three to five years to complete. Among the significant issues they will address is whether to require companies to recognize in the income statement differences between actual and estimated plan assets and changes in the estimate of benefit obligations. Such a requirement could introduce significant volatility in earnings.

On a related note, the Pension Protection Act of 2006 was signed into law in August. It changes the way pension plans are designed and administered, increases plan funding requirements, and strengthens plan reporting and participant disclosures. The provision of the Act covering funding requirements for single-employer defined benefit pension plans is key and directors should be familiar with it. It establishes a 100% funding target for plan years beginning after December 31, 2007. Thus, starting now and through 2008, many companies will have to invest substantial amounts of cash into their pension plans to meet the requirement.

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### Directors' actions

- Ensure management is ready for the new accounting and disclosures required by FAS 158 and discuss the implications for the company's financial statements and for financial covenants in debt or other agreements
- Understand the differences between executive and employee pension plans and the transparency of related disclosures, consider which elements may cause shareholder concern, and determine whether any revisions to plans are needed
- Discuss with management the company's plans to achieve a 100% funding target for defined benefit pension plans

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<sup>2</sup>Special Report: Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers, SEC, June 16, 2005.

## Uncertain tax positions

In the normal course of business, companies often try to reduce their overall tax burden and minimize or delay cash outflows for income taxes. The average corporate tax return includes numerous tax positions that are subject to significant and varied interpretation. Thus, there is often uncertainty about whether a particular position taken on a tax return ultimately will withstand the scrutiny of the relevant taxing authority.

To address the significant diversity in accounting practices in this area and to provide investors with a clearer understanding of the company's tax positions, the FASB issued FIN 48, *Accounting for Uncertainty in Income Taxes*, in July 2006. It's effective for fiscal years beginning after December 15, 2006, so calendar-year-end companies will start to apply it for their first-quarter 2007 financial reports.

FIN 48 provides a new and comprehensive two-step structured approach to account for uncertain tax positions.

*Step 1: Recognition* – A tax benefit may be reflected in the financial statements only if it is “more likely than not” (a probability of greater than 50%) that the company will be able to sustain the tax position with taxing authorities, based solely on its technical merits.

*Step 2: Measurement* – If a tax benefit meets the recognition criterion, the company should record the largest amount that is more likely than not to be sustained with taxing authorities.

For benefits that don't meet the recognition threshold, a company will record a reserve for the full amount of the tax benefit—essentially eliminating any income statement benefit from the position.

Other significant provisions:

- Companies have to reassess continually whether the tax benefit they're claiming should be recognized, as tax positions are subject to change in subsequent periods based on new information. Thus, a tax benefit recognized in one period may be “derecognized” in another (and vice versa).
- Companies will have to disclose significantly more detail about tax risks and reserves than in the past.

The application of FIN 48 will require companies to use considerable judgment. We encourage management to use a risk-based (i.e., top-down) approach to identify uncertain tax positions and determine what and how much to document based on their materiality and complexity. The nature, size, and complexity of their tax positions will drive the documentation and analysis companies need to do. This will entail a meaningful amount of work for some companies, as well as changes to processes and procedures.

One impact of FIN 48 is that it likely will lead to greater income statement volatility. Another is that the greater transparency will provide investors, analysts, and, potentially, even taxing authorities more information for making assessments about companies' tax positions.

To help executives and directors understand the business implications of FIN 48, PricewaterhouseCoopers published “Lifting the Fog: Accounting for Uncertainty in Income Taxes.”<sup>3</sup> In particular, the paper highlights FIN 48's impact on companies' tax and finance resources, internal controls, tax planning posture, and broader financial reporting.

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### Directors' actions

- Ensure management has developed a multidisciplinary approach to implement FIN 48, covering all implementation phases and addressing its impact on internal controls
- Ensure the board's values and risk tolerance are properly communicated and understood by all employees, including those who determine the level of risk the company will assume in tax return filings
- Understand the financial statement implications of adopting FIN 48 and discuss with management the communications that are necessary with other parties (e.g., shareholders and analysts)

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<sup>3</sup>Available at [www.pwc.com/uscorporategovernance](http://www.pwc.com/uscorporategovernance).

## Evaluating financial statement errors

Reaching materiality judgments continues to be a challenge for companies.

Historically, companies used two different methods—either the “rollover” or the “iron curtain” method, described in the box—to determine whether a financial statement error was material. If they concluded it wasn’t material, they didn’t amend their financial statements to correct it.

In September 2006 the SEC issued Staff Accounting Bulletin 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*. SAB 108 requires companies to quantify all known financial statement errors under both methods—known as the “dual method” approach—and use whichever method yields the greater error. And while companies will apply SAB 108 on an ongoing basis to analyze errors, it has a special, one-time effect when companies first apply it. Companies will apply SAB 108 in years ending after November 15, 2006.

### Two methods of valuing errors

- The “*rollover*” method focuses primarily on the impact of a misstatement on the income statement—including the reversing effect of prior-year misstatements—but can lead to the accumulation of misstatements on the balance sheet.
- The “*iron curtain*” method focuses primarily on the effect of correcting the period-end balance sheet, with less emphasis on the reversing effects of prior-year errors on the income statement in the period of correction.

### One-time effect

In the first year it’s applied, companies will record a cumulative effect adjustment to retained earnings for items that are material under the dual method approach and will provide robust disclosure of the components of the adjustment. This one-time allowance is available only under a limited fact pattern and is not a general amnesty for prior-period errors. Rather, companies should evaluate all known errors under the company’s historical method to ensure that prior statements were not materially misstated.

### Ongoing application

Going forward, companies will be required to apply the dual method approach to evaluate errors identified. This new approach is heightening sensitivity to the possibility that immaterial errors, if left uncorrected, might cross the materiality threshold in the future and force a restatement.

While SAB 108 reduces an element of diversity in practice, there continues to be debate surrounding materiality judgments. One issue is the extent to which qualitative factors override quantitative information. While qualitative factors often will make a relatively minor amount material, there are situations in which qualitative factors may allow companies to determine that a significant amount is immaterial. For example, this fact pattern may be present in break-even situations or when discontinued operations have been sold. The SEC has acknowledged the diversity in materiality judgments and is encouraging members of the financial reporting community to engage in the debate. PricewaterhouseCoopers supports the application of judgment in materiality determinations and welcomes further discussions.

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## Directors' actions

- Review management's evaluation of the nature, amount, and circumstances associated with all errors included in a SAB 108 cumulative effect adjustment to ensure that prior-period financial statements were not materially misstated; review adequacy and transparency of related disclosures
- In instances where management concludes it is not necessary to correct all identified errors, both in connection with SAB 108 and going forward, critically evaluate the basis for this judgment

## Examining restatements

Based on available data at the time of this writing, the largest companies are expected to have fewer restatements in 2006 than in prior years. But the smallest companies—those with market capitalizations under \$75 million—are experiencing a substantial increase in the number of restatements. While some of these restatements are driven by an environment that encourages companies to self-report errors, they also reflect the complexity of accounting standards, increased regulatory scrutiny, and relatively narrow materiality levels.

An Audit Analytics™ study of restatements in the first half of 2006 shows the most common reasons for restatements relate to cash flow statements, revenue recognition, deferred stock-based compensation, tax accounting, hedging/derivatives, and debt/equity issues.

A 2006 SEC study reviewing information on restatements disclosed in filings from 2003 to 2005 found that well over half of the restatements were caused by ordinary record-keeping deficiencies, such as a company capturing information incorrectly or incompletely, or by simple misapplication of accounting standards.

The declining trend in restatements among large companies is encouraging. But the SEC's findings in particular reinforce the importance of sound internal control to companies' ability to present reliable financial statements.

## Current value (or fair value) measurement

US generally accepted accounting principles (US GAAP) were built on a foundation of using historical costs to measure most assets and liabilities. However, over the years there has been an increasing trend to measure certain financial assets and liabilities, particularly those that trade in liquid markets, at current value. This practice is especially relevant for financial institutions. Now there is a widening debate: Should companies measure more of their assets and liabilities at current value? How can they do so reliably, if the markets for certain types of assets are illiquid? What measures—historical cost, current value, or some other type of measure—improve financial reporting and the information that investors and creditors need in order to analyze companies?

Most people agree that current value is the right measure for assets that trade in active and liquid markets. However, for all other assets and liabilities, there are varying points of view as to whether current value or historical cost is the more appropriate measure. The controversial measurement question has to be answered by finding the right balance among three factors: sound accounting that withstands rigorous scrutiny, cost-effectiveness and practicality for companies, and better serving the needs of the users of the financial statements.

PricewaterhouseCoopers recently conducted a survey of investors on measuring assets and liabilities. The survey makes clear that investors are wary of current value measures applied to anything other than highly liquid financial assets and liabilities and assets deemed to be investments or available for sale. If current values are to be provided, they suggest a number of solutions focused particularly on disclosures that will allow them to evaluate management's assumptions and methods in defining current values.

There is not the only voice questioning the increased use of current values. Others note that analyzing a company's operating performance may become more difficult when different measurement bases are used. Still

others note that because current value measurements change from period to period, a company's reported earnings may be more volatile.

### How to measure

In 2006, the FASB issued a new standard, FAS 157, *Fair Value Measurements*, to assist companies with determining *how* to measure financial statement items at current value. Because current value measures are required by over 60 accounting standards, the financial statement effect of this standard will be pervasive. The standard also provides investors with a clearer picture of the approaches companies use to determine current value measures. Calendar-year-end companies will adopt the standard in 2008.

FAS 157 clarifies that assets and liabilities measured at current value should be based on data and assumptions that would be used by others in the relevant market for the asset or liability. Current value should not be based on management's data and assumptions or intended use of the asset or liability. To assist companies in measuring the current value of assets and liabilities, FAS 157 establishes a hierarchy that indicates the relative reliability of the current value measure.

- Level 1 Observable inputs that reflect quoted prices (unadjusted) for *identical* assets or liabilities in *active markets*
- Level 2 Inputs other than quoted prices included in Level 1 that are observable for the asset or liability through corroboration with observable market data
- Level 3 Unobservable inputs (e.g., a company's internal information)

FAS 157 requires expanded disclosures to provide insight into the reliability of current value measures, including separately disclosing assets and liabilities by level in the hierarchy.

## Fair value option

In a related development, the FASB plans to issue in 2007 a new standard that will allow companies to elect to measure at current value any financial asset or liability. Many financial institutions are likely to consider how this option will allow their financial reporting to better reflect their management of asset and liability exposures. The FASB also plans to begin exploring the question of when companies may elect to measure nonfinancial assets and liabilities at current value.

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## Directors' actions

- Gain a high-level understanding of FAS 157 and its significant provisions
- Begin to understand the impact of any expected adjustment to the financial statements in the year of implementation, which for calendar-year-end companies is 2008
- Listen in on the current value debate as it develops, and urge your company to participate through comment letters to standard setters and relevant forums; the issue has broad strategic implications

## International developments

On the international front, progress continues toward convergence of both accounting and auditing standards, important initiatives that contribute to the free flow of capital globally and achieve substantial benefits for all capital market stakeholders. (See the discussion on international auditing standards in the Update at the Regulators section.)

The FASB and IASB remain committed to working with each other to converge US accounting standards and International Financial Reporting Standards (IFRS). In fact, they have launched a major joint project to improve and align their conceptual frameworks, the first important step in driving convergence around common standards. Other joint projects underway include standards on business combinations and income taxes. A number of longer term projects are also in the works, such as one on revenue recognition, and are expected to result in significant changes to both US GAAP and IFRS.

PricewaterhouseCoopers supports the continued convergence of standards. We recognize that it may take years to reach the important goal of a single set of standards, but progress already is occurring. In the near term, there will be two standard setters and a mix of standards, some prepared and issued jointly by the FASB and IASB, and others issued independently but under the auspices of the convergence framework. Ultimately, we expect the two standard setters will achieve a level of "substantial equivalence." This equivalence would allow the SEC, among other considerations, to eliminate its requirement that non-US companies reconcile their IFRS financial statements to US GAAP. We trust that both standard setters will move with a sense of urgency toward this goal.

## Perspectives on corporate reporting

The convergence of IFRS and US GAAP is an important process for the global capital markets. Developing a single set of high-quality accounting standards will benefit global investors by simplifying investment analysis, facilitating comparability, and enhancing the overall quality of financial information reported worldwide. Beyond the fundamental benefit of communicating in a common accounting language, convergence has the potential to create a new standard of accountability and greater transparency, values that are important to all market participants.

The process of converging to a single set of high-quality accounting standards represents an unprecedented opportunity to address long-standing issues and bring broad-based improvements to the reporting model. Over the past decade, the capital markets have experienced a dramatic evolution in the types of business information and the means by which that information is produced, reported, and consumed. While the financial reporting model steadily evolves from year to year as specific standards are written, there is a growing awareness among standard setters, regulators, companies, and investors that it is time to take a fresh look at the reporting model to ensure that relevant, reliable, and understandable information is delivered to the markets as efficiently as possible. In the United States, the primary concern is that the financial reporting model is overly complex, laden with rules and exceptions, and difficult to apply. Too often it fails to reflect the economic substance of transactions and financial position. Convergence provides a platform to address some of those fundamental concerns. Global accounting standards by nature will have to be more principles-based to encompass the range of economies and operating environments around the world.

Another concern, potentially controversial, is the need for the reporting model to provide richer contextual information that better serves investors. Investors have expressed concern that existing reporting does not fully deliver the key information they need. They complain that reporting offers only a limited historical picture, without providing a transparent view into the underlying operating performance delivered by management. They want to understand the investment returns generated by management and gain insight into future expectations.

In PricewaterhouseCoopers' view these are manageable wants and needs, but to address them the key parties—companies and investors—need to engage each other in a richer dialogue to bring their shared thinking to the attention of standard setters. Companies, as preparers of financial reports, have a history of engaging in the standard-setting process through comment letters and other means, while investors generally have been much less involved. Even when investors engage, they tend to do so separate and apart from companies. Companies and investors would benefit from sitting down together to look at the issues and determine collectively what is relevant and reasonable. That kind of collaboration would make a powerful contribution to standard setting and has the potential to revolutionize the reporting model of the future. Preparers and investors are the principals in market transactions. Their views, and even more powerfully their joint views, will be influential.

We believe that the reporting model of the future should embrace the following fundamental principles:

- Provide a balanced and understandable representation of a company's current economic position and performance
- Increase the decision-usefulness for investors
- Minimize the use of accounting rules in favor of principles-based standards
- Address companies', investors', and other stakeholders' needs and concerns, including cost-benefit considerations
- Allow for a reasonable level of comparison across companies

# Internal control reporting

Although larger companies have been reporting under the 404 regime for a few years now, concerns remain over the cost of 404 and the extent to which it diverts management's attention from strategic issues. And the smaller companies that have not yet reported on their evaluation of internal control over financial reporting (ICFR) have been particularly vocal about the cost of compliance, especially relative to their resources. There has been intensive lobbying around 404, covering the continuum from reducing the scope of what's covered in a 404 evaluation, to excluding smaller companies from the requirement altogether.

So the focus continues on ways to reduce the costs of internal control reporting while preserving the demonstrated benefits of an audit of ICFR. Toward this end, in December 2006, the SEC proposed guidance to increase the effectiveness and efficiency of management's evaluation process. Also in December, the Public Company Accounting Oversight Board (PCAOB) proposed a new standard for an audit of ICFR to replace its current auditing standard, AS 2.

Both the proposed guidance for management and the proposed auditing standard are expected to be finalized in the late spring of 2007. Both are principles-based, encourage the exercise of significant judgment, and promote a top-down, risk-based approach, appropriately scaled to a company's specific nature and characteristics.

As the audit committee oversees the company's internal control reporting and the external auditors, its members will want to understand the impact of these proposals and their implications for the company, for management, and for the scope of audit work.

PricewaterhouseCoopers believes the proposed changes provide an opportunity for both management and the auditors to increase efficiencies while still maintaining a focus on effectiveness—by focusing on what's most important while eliminating unnecessary efforts and while preserving a quality assessment. Companies and their auditors should work collaboratively to determine how best to apply these proposals to their individual facts and circumstances. The impact of these proposals will vary from company to company depending on the robustness and efficiency of current processes. The audit committee will want to ensure that management and the auditors are working together on this analysis, and that it—the audit committee—fully understands the collective view on potential areas for enhanced efficiencies and the focus on maintaining the quality of work in order to complete both management's and the auditors' assessment.

## Interpretive guidance for management

When the rules around 404 first were implemented, there was no guidance for management on how it was supposed to carry out its evaluation of ICFR. By default, management often used AS 2 as a guide. This new SEC guidance is intended to fill that void.

With the new guidance, management should be able to increase the effectiveness and efficiency of its ICFR evaluation process by taking a top-down, risk-based approach to determine where to focus its effort. Under the guidance, companies that already have developed an effective approach to evaluating ICFR are not required to change their evaluation process.

Specifically, the proposed guidance addresses:

- *Identifying material financial reporting risks and the controls addressing them.* Management should use its judgment to determine which areas are material and pose a significant risk to financial reporting and to identify the key controls that address those risks.
- *Evaluating controls' operating effectiveness.* Management may use various approaches in carrying out its assessment and is encouraged to leverage existing monitoring processes.
- *Reporting results.* A framework supports management in reaching judgments about whether any control deficiencies are material weaknesses. It also directs management on reporting issues, including conclusions when ICFR is not effective.
- *Documenting the assessment.* The guidance describes the nature and extent of documentation management should maintain to support its control assessment and clarifies that the documentation can take different forms. Further, it recognizes that management may have only limited documentation for controls it observes as part of its ongoing, daily activities.

The quality of management's assessment is inherently linked to the amount of work the auditors will need to do. As a result, management and the auditors should work together in a coordinated manner on implementing the new guidance, in order to maximize efficiencies.

## New standard for external auditors

Concurrent with the SEC's proposed guidance, the PCAOB proposed a new auditing standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements* (known as AS 5), intended to replace AS 2. It directs auditors to take a top-down, risk-based approach, reinforcing the greater judgment auditors should exercise in tailoring their audit of ICFR to individual companies.

AS 5 is intended to:

- Focus the audit on the matters most important to ICFR—by emphasizing the need for professional judgment in the auditor's top-down, risk-based approach
- Eliminate unnecessary procedures—such as the opinion on management's process for assessing ICFR
- Scale the audit for companies of various sizes—with principles auditors can use for smaller company audits<sup>4</sup>

AS 5 also simplifies the ICFR audit requirements, making them easier to apply and allowing for greater professional judgment, while still retaining most of the core principles in AS 2. The following are a few examples of ways in which AS 5 facilitates a top-down, risk-based approach and provides greater opportunity to apply professional judgment:

- *Scoping.* For companies with multiple locations, AS 2 required auditors to test controls over a "large portion" of the company's operations and financial position. AS 5's testing requirements place more focus on risk, so auditors can use greater judgment in determining which locations to visit. Auditors don't have to test locations or business units that, individually or together, do not have a reasonable possibility of having a material misstatement in the consolidated financial statements.
- *Using the work of others.* Under AS 5, auditors have more flexibility in how they rely on the work of others. For example, auditors can use the direct assistance of others to perform walkthroughs and can rely on the work of others for certain aspects of the control environment.

- *Using knowledge from prior years' audits.* AS 5 allows auditors to use their knowledge gained from prior years' audits in determining the nature and extent of testing in some areas. Auditors have greater flexibility now to reduce testing in some areas based on that knowledge.

While external auditors can use greater judgment in performing their audits, they need to accumulate sufficient evidence to support their audit opinion. Thus, the amount and nature of work management does, as well as the competence and objectivity of those performing the work, will impact the auditors' work. Accordingly, external auditors will need to coordinate closely with management.

PricewaterhouseCoopers strongly supports the changes anticipated by this proposed new standard. While the standard clearly maintains auditors' responsibility to obtain "sufficient, competent evidential matter" to base our opinion on, we believe the flexibility of AS 5 and the ability to apply greater professional judgment will result in a more effective and efficient integrated audit. We are committed to working with management to coordinate our audit with management's evaluation and we believe that planning should start now.

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### Directors' actions

- Stay current with regulator activity, asking management and the external auditors to provide periodic updates on developments
- Ensure that management and the external auditors are actively planning for the proposed changes in a coordinated fashion
- Understand the impact of the SEC's interpretive guidance on management's process
- Understand how any changes to management's evaluation process impact the auditors' ability to rely on management's work
- Discuss with the external auditors changes to audit scope and the nature, timing, and extent of testing
- Maintain the tone at the top, reinforcing the importance of effective internal control over financial reporting

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<sup>4</sup>Appendix B presents additional guidance and Section 404 compliance dates for smaller companies.

## Newly public companies

In December 2006, the SEC adopted final rules for the timing of internal control reporting compliance for newly public companies. Under the rules, a newly public company (e.g., a company that completes an IPO or otherwise becomes subject to the Exchange Act reporting requirements) is not required to provide either a management assessment or an auditor attestation report on internal control over financial reporting until it has filed an annual report with the SEC for the previous fiscal year.

Update at the regulators

## Important developments at the SEC

### New faces

With a number of vacancies remaining in key leadership positions at the end of 2005, it is no surprise there are many new faces at the SEC. For starters, Kathleen Casey was appointed Commissioner for a term to expire in 2011. Conrad Hewitt was appointed Chief Accountant. He will lead continuing efforts in several critical areas such as Sarbanes-Oxley internal control provisions, reducing complexity in financial reporting, and promoting the convergence of US and international accounting standards. Another significant appointment was that of John White as Director of the Division of Corporation Finance. One of his first efforts was to direct the rule-making activities relating to the new executive compensation disclosures. Dr. Zoe-Vonna Palmrose joined the SEC as a Deputy Chief Accountant. One of the other Deputy Chief Accountants, Scott Taub, resigned in late November. Mr. Taub played a key role in the SEC's implementation of the accounting reforms under the Sarbanes-Oxley Act.

### Areas of focus

The SEC's top priorities in 2007 will continue to focus on improving Section 404 reporting (see the Internal Control Reporting section), simplifying rules, and leveraging technology to enhance reporting and analysis.

The SEC is looking at its approach to rule making. Its objective is to issue simpler rules that encourage companies to use judgment and be appropriately transparent. This approach also should help shift companies away from pointing to language in the rules and questioning, "Where does it say I need to disclose this information?" or "Where does it say I can't do that?"

Similarly, a continuing focus is on "plain English" disclosures that allow readers to understand complex financial statements without having to earn a degree in law or accounting. The SEC expects companies to present complex information in a clear and concise manner that is understandable to a broad audience.

On the technology side, the SEC is pursuing a number of initiatives, including e-proxies, as discussed under Empowering Shareholders, and the use of interactive data (XBRL, or eXtensible Business Reporting Language) to drive improved and timely access to company information. And it is posting comment letters and companies' responses on its website, posting registration statement effectiveness notices on its public company disclosure system (EDGAR) website, and adding a full-text search capability to EDGAR's functionality.

XBRL is an enabling technology. It allows investors and others who use business reporting information to access that information through the Internet and analyze it easily. And, XBRL is expected to lower costs because it allows companies to streamline their processes by automating the collection, validation, analysis, and reporting of information.

The SEC is supporting greater adoption of XBRL by allocating substantial resources to transform EDGAR from a "form-based electronic filing cabinet" to a "dynamic real-time search tool with interactive capabilities" and to fund the completion of the US GAAP taxonomy that will allow companies to tag their financial information for both internal management reporting and external consumption.

Although the XBRL filing program the SEC has established is currently voluntary, the focus and resources being brought to bear suggest strongly that in the future the SEC will require companies to submit their filings using XBRL.

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### Directors' actions

- Discuss with management how the company's internal reporting processes need to change, if at all, to be ready for XBRL
- Discuss with management the impact and benefits of participating in the voluntary XBRL filing program to gain experience now—before it becomes mandatory

## What directors should know about the PCAOB

The Sarbanes-Oxley Act mandated the formation of the Public Company Accounting Oversight Board (PCAOB) to help restore investor confidence in the work of auditors. As well as setting auditing and auditor independence standards, the PCAOB registers and inspects firms that audit public companies.

In June 2006, the SEC appointed its second chairman, former Federal Reserve Board Governor Mark Olson. The PCAOB's agenda has been and continues to be dominated by efforts to strike the right balance between effectiveness and efficiency in audits of internal control over financial reporting. To that end, the PCAOB proposed Auditing Standard No. 5 to replace AS 2. PricewaterhouseCoopers supports the AS 5 proposal, which is consistent with many of the points we raised in response to a request for feedback on the current standard, and which is discussed in more detail in the Internal Control Reporting section.

Now in its fourth year of operation, the PCAOB remains relatively young in its lifecycle as a regulator and is experiencing certain challenges. For example, there is concern over the time it takes to issue inspection reports. The lengthy period between when audits are finished and when the inspection reports are issued doesn't allow audit committees to amalgamate these reports on a timely basis with other pertinent information when making their auditor retention decisions.

The PCAOB's actions have had and will continue to have significant impact on auditors' ability to use professional judgment. We and the entire profession are working with the PCAOB and would hope the inspection process will evolve to support the auditors' greater use of professional judgment.

## International auditing developments

Auditing is continuing to move beyond national borders, and in 2006 more countries either adopted or made further strides toward adopting International Standards on Auditing (ISAs). Approximately 70 countries have adopted or are planning to adopt ISAs, including Australia, China, Canada, Hong Kong, and the UK.

Adoption of ISAs is a cornerstone of the European Union's 8th Company Law Directive on Statutory Audit, released in June 2006. And, as further evidence of the acceptance of ISAs, the World Federation of Exchanges, an international organization of 56 major stock exchanges around the world, has endorsed them.

Additionally, the International Forum of Independent Audit Regulators (IFIAR) was formed in September 2006 to share knowledge of the audit market environment and promote collaboration in regulatory activity, among other goals. The PCAOB plans to increase its participation in IFIAR, with the ultimate goal of enhancing mutual working relationships.

# A conversation on boardroom challenges with the corner office

An interview with Robert P. May, Chief Executive Officer of Calpine Corporation and director at Charter Communications, Inc.

*Mr. May is known among his colleagues as a turnaround expert. The title is well deserved. In 2003, he nursed a near-bankrupt HealthSouth back to financial health and restored its reputation for management integrity when he took over as acting CEO following the scandal it faced. Before that, while holding key executive management positions, Mr. May led major operational and financial improvements at several top US companies, including Charter Communications, Inc. and Cablevision Systems Corporation. Drawing on his experience both as a CEO and as an independent director, he provides his views on today's challenges in the boardroom.*

**PwC:** The director's role has changed significantly in recent years. What should today's directors be thinking about?

**May:** A substantial amount of time and effort is now required from board members, and a much stronger commitment than in the past. When Sarbanes-Oxley first came along, directors were well aware that it would make new demands on us—and it seems as if every year those demands continue to increase. So you have to stop and think: Do I want to be a director, and if so, how many boards can I practically serve on? Given today's conditions, that is the most important issue to think through.

**PwC:** The commitment required to serve on a board has increased dramatically, and the pool of willing candidates appears to be shrinking. What are the long-term implications of this dilemma?

**May:** I don't think we'll feel the true impact of this issue for several years because enough folks of my generation are willing to serve on boards. I question whether the next generation will be as eager. Will they have the stomach for board membership after hearing about all the turmoil and uncertainty that surround director liability? I also wonder about the impact of the stock option backdating investigations. The entire situation reinforces the fact that you don't know what you don't know. And to my mind that's the most difficult aspect of board membership. I hope that the next generation is up to the challenge.

**PwC:** Does it make sense for a CEO to serve on the boards of other companies, or is it best to restrict the CEO's participation on boards?

**May:** I think it's wrong *not* to allow your CEO to sit on other boards. Serving on another board can help CEOs continue to develop professionally and become more well-rounded. It exposes them to how other companies and directors work, and enables them to become more effective in working with their own board.

## The compensation issue

**PwC:** What's the next big issue directors will face?

**May:** Clearly, it's compensation, and unfortunately there are no easy answers. It's a difficult and volatile issue; it gets people upset. Frankly, board members may not be especially effective on the compensation committee unless they have significant experience in human resources or compensation-related issues. Determining compensation is subjective, and decisions will always be open to criticism. Members of the compensation committee must rely heavily on personal judgment, past experience, common sense, and outside advisors. Good outside advisors in this field are a limited resource. So even when directors make the most informed decisions, they are without question exposing themselves to criticism.

**PwC:** Will the new SEC disclosure rules help?

**May:** I think they'll improve transparency—but they won't resolve the issue and they'll increase the drumbeat of public criticism. If the public believes that members of management are overcompensated, it will criticize the board even if the board's decisions are backed by sound reasoning and expert advice. It's something of a no-win situation.

In some ways, the compensation committee will have a tougher job than the audit committee. Sarbanes-Oxley and other related developments have placed significant regulatory requirements on the audit committee, making its work more of a science than in the past. It will be very hard to apply science to the work of the compensation committee; you can't regulate judgment. Ultimately, the new disclosures are the entire board's concern. Although setting goals and objectives is the compensation committee's responsibility, overseeing those objectives is a responsibility of the board as a whole.

## Telling the whole story

**PwC:** As a CEO, you're involved in day-to-day operations. As a director, you're not. What actions can you take in both roles to ensure that the financial statements tell the whole story?

**May:** As CEO, you need to spend time consulting with general counsel, financial and operating management, and outside auditors to confirm that the information you're getting accurately represents the company and reflects its performance. It sounds simple, but it's very important. My experience at HealthSouth, a company at which significant fraud occurred, has taught me that it's very difficult for the board or anyone else to detect employees with the intent to commit fraud. Still, the CEO must do his or her part by checking the accuracy of information received, learning the details of the business, and understanding the various finance functions. My outlook on this topic is based on something I learned many years ago: You can't manage what you can't measure. So I tend to create metrics, if they don't already exist, which allow me to compare nonfinancial information with financial information. That gives me a clearer picture of the company.

As an outside director, you need to read the current financial statements and evaluate their degree of transparency. If in your view the financial statements aren't as transparent as they should be, you need to question management or discuss the matter with the audit committee. It's very good practice for board members to consider nonfinancial metrics on a regular basis. They allow the board to identify the key levers in the business and ensure that these levers match up against the financials. At Charter Communications, the board regularly tracks 12 metrics, half of which are nonfinancial. We developed these metrics to make the relationship more visible between the company's financial condition and operating metrics. I believe it's a responsible and reasonable approach.

## The relationship with management

**PwC:** From the perspective of both a CEO and a director, what advice do you have for board members concerning the board's relationship with management?

**May:** The most important point I've learned over the years is that the board should be more involved, not less involved. I'm a strong advocate for transparency between the CEO and the board. And I'm a particular fan of having strong board members and really using them as a resource. My advice to directors serving on boards that currently don't have an open relationship with management is they should do whatever they can to change the situation. Unfortunately, I know of a few CEOs who approach the board even now with the old-style attitude of "I'm management and you're not." When I hear about these situations, I can't help but think that there's likely to be trouble down the road.

**PwC:** Has the more active approach directors are taking to fulfilling their responsibilities strained the relationship between management and the board?

**May:** Boards are definitely asking tougher questions today than they were several years ago. Most management teams have adjusted to this new tone in the boardroom, although I have seen several struggles with it. If management doesn't realize that the board's role has changed, its relationship with the board won't be very successful. The board exists to challenge and help management, not to agree with everything management says. But there are also right and wrong ways to approach management. I've served on boards with directors who challenge management just to prove they're smarter. When this happens, other board members usually catch on and offer a little coaching to get them back on track.

PwC: How do you handle a disruptive board member?

May: Not dealing with the situation is a big mistake because it can ruin boardroom harmony and prevent the development of a cooperative relationship between the board and management. To address the situation, you should approach the chair with the issue, provided that the chair is not the CEO. If the chair is the CEO, you should approach the most senior outside board member. If the senior board member prefers not to address the disruptive board member on behalf of the board, then you should take it upon yourself to deal with the problematic member as courteously as possible. In my experience, if you are concerned about a particular board member, others probably feel the same.

### Empowering shareholders

PwC: How should directors stay in touch with shareholders, given the ongoing activism?

May: As an outside director, you have to rely on the company's investor relations department. In my opinion, a board should hear from its investors on a regular basis—if not in person, then in the routine briefing material distributed before meetings. Maintaining communication with investors and stakeholders provides the board with informal feedback from the marketplace—identifying which issues, if any, require board attention. In my experience, this is the best avenue available to directors for learning what people really think about the company.

PwC: What is your view on majority voting?

May: I'm a bit schizophrenic on the topic. On the one hand, majority voting seems very reasonable to me: If you can't get the support of the majority of shareholders, you shouldn't be on the board. On the other hand, board members sometimes must take unpopular stances. They may be the proper ones to take, but wholly unpopular with a certain group of shareholders. I don't see how it could be fair for those decisions to weigh against a board member in the voting process. Don't misunderstand: I generally agree with the idea of majority voting, but I can see how it might be used in an unhealthy way.

### Independence, equity, courage, and ...

PwC: You once said, "To be a good board member, you need independence, equity, and, above all else, courage." Would you add anything to that statement today?

May: I have one additional insight, equally simple but, to my mind, important. If you're serving on a board, be sure that you can answer this question in the affirmative: "Am I having fun?" Board membership should be hard-working. It should be for the shareholders. It should be for the best interest of the company. But it should be personally satisfying and enjoyable.

# Other noteworthy developments

## Noteworthy reports

### Committee on Capital Markets Regulation

Prompted by concerns that other international markets are gaining dominance, the Committee on Capital Markets Regulation was established in September 2006 to study ways of improving the competitiveness of US markets. The Committee includes US business, financial, investor, corporate governance, legal,

accounting, and academic leaders. An interim report, issued in November, presents the Committee's findings and makes specific recommendations for changes in capital markets regulation. The interim report focuses on equity markets. The Committee plans to explore other aspects of US capital markets over the next two years.<sup>5</sup>

#### Key recommendations of the Committee on Capital Markets Regulation

1. *Regulatory process.* The SEC and stock exchanges should move to a more risk-based process, emphasizing the costs and benefits of proposed rules and regulations. Once rules have been issued, periodic evaluations should ensure they are meeting their objectives at a reasonable cost. In addition, regulations and guidance should be principles-based, to the extent possible, rather than prescriptive. And there should be better coordination among national regulators and between federal and state authorities.
2. *The private and public enforcement system.* Both the private litigation system and the civil and criminal enforcement system need adjustments to make financial markets more secure and more competitive. Recommendations include:
  - The SEC providing greater clarity for Rule 10b-5, which drives much of securities litigation
  - Using criminal enforcement against a company as a last resort reserved solely for pervasively criminal enterprises
  - Congress considering placing caps on liability or safe harbors for gatekeepers, such as auditors and independent directors
  - The SEC changing its indemnification policy to protect directors who have acted in good faith. Independent directors also should be able to rely in good faith on audited financial statements or an auditor's review report and on representations of senior officers—after boardroom discussion
3. *Shareholder rights.* In light of the concern that the United States is falling behind best practices in other countries for shareholder rights, shareholders should have the right to vote on takeover defenses and the adoption of dispute-resolution procedures. In addition, majority voting policies, rather than plurality, should be adopted and the SEC should address issues of shareholders' access to the director nomination process.
4. *Changes to Section 404 of the Sarbanes-Oxley Act.* Regulatory changes to Section 404 (which impact its implementation), as opposed to statutory changes, are needed to reduce costs, while preserving its benefits of stronger internal controls, greater transparency, and increased accountability. Both the SEC and the PCAOB should allow increased exercise of auditor judgment and greater auditor reliance on the work of others, where appropriate. [As noted under Internal Control Reporting, both the SEC and the PCAOB are addressing many of these issues in their revised guidance.]

<sup>5</sup>The report is available at [www.capmksreg.org](http://www.capmksreg.org).

## Breaking the short-term cycle

Concerned about the overemphasis, by both companies and investors, on short-term performance, the CFA Centre for Financial Market Integrity and the Business Roundtable Institute for Corporate Ethics conducted a series of symposia to address the issue of “short-termism.” Participants included public companies, analysts, asset and hedge fund managers, institutional investors, and individual investors—providing a range of perspectives.

A report entitled *Breaking the Short-Term Cycle: Discussion and Recommendations on How Corporate Leaders, Asset Managers, Investors, and Analysts Can Refocus on Long-Term Value* was published in July 2006.<sup>6</sup> The recommendations for mitigating “short-termism” fall into a number of categories; are directed at companies, directors, investors, and others; and are summarized in the box.

### Earnings guidance

1. Stop providing quarterly earnings guidance.
2. For companies with strategic needs for providing earnings guidance, adopt practices that use a consistent format, range estimates, and appropriate metrics reflecting overall long-term goals and strategy.
3. Support companies in transitioning to higher quality, long-term, fundamental guidance practices.

### Incentives and compensation

1. Align executive compensation with long-term corporate goals and strategies and with long-term shareholder interests.
2. Align asset manager compensation with long-term performance and with long-term client interests.
3. Improve disclosure of asset managers’ incentive metrics, fee structures, and personal ownership of funds they manage.
4. Encourage asset managers and institutional investors to invest in companies that use effective, long-term, pay-for-performance criteria in determining executive compensation.

### Leadership

1. Back executives who communicate long-term strategic objectives and related performance benchmarks rather than quarterly earnings guidance.
2. Support analysts and asset managers in adopting a long-term focus.
3. Encourage institutional investors to focus on long-term value, including in their evaluation of asset managers.

### Communications and transparency

1. Encourage companies to provide more meaningful, and potentially more frequent, communications about strategy and long-term vision, including more transparent financial reporting of operations.
2. Encourage management’s use of plain language communications to replace accounting and legal language so there is less need for earnings guidance.
3. Use the letter to shareholders to explain why the company is a sound long-term investment.
4. Integrate investor relations and legal disclosures and eliminate boilerplate language and legalese.
5. Encourage institutional investors to make long-term investment statements to their beneficiaries.

### Education

1. Encourage companies to have dialogues with asset managers and other financial market leaders to better understand how the marketplace values them.
2. Educate institutional investors and their advisors (e.g., consultants, trustees) on short-termism and on their long-term fiduciary duties.
3. Support education initiatives for individual investors to encourage a focus on long-term value creation.

<sup>6</sup>The report is available at [www.cfapubs.org/toc/ccb/2006/2006/1](http://www.cfapubs.org/toc/ccb/2006/2006/1).

## Global Capital Markets and the Global Economy: A Vision from the CEOs of the International Audit Networks

The importance of the increasingly global capital markets and the various stakeholders in the financial reporting process was highlighted in a paper entitled “Global Capital Markets and the Global Economy: A Vision from the CEOs of the International Audit Networks,” written by the six largest global accounting firm networks and released in November 2006.<sup>7</sup> The paper was written to begin a dialogue between the accounting profession and other stakeholders in the financial reporting process. In the paper, the CEOs put forth several recommendations for short-term changes, while at the same time calling for a discussion about how company reporting ultimately may evolve due to new technology, enhanced information flows, and investor needs.

Central to the paper is the critical need for reliable, relevant, and timely information for various stakeholders. The firms call for international and US accounting standard setters to complete their convergence projects and, in particular, to issue principles-based standards. In addition, the paper points to convergence of auditing standards and auditor oversight as next steps. Over the longer run, the firms agree that the current system of reporting and auditing company information will need to evolve as more nonfinancial information becomes available, is customized to the user, and can be accessed more easily and frequently—in effect, a new business reporting model.

The firms envision the new business reporting model will be driven by the wants of investors and other users of company information, and the information produced will be forward-looking, although based on historical measures. For example, nonfinancial measures such as customer satisfaction may help predict how well a company will perform in the future. The new model also will generate information capable of being easily accessed through new Internet-based reporting technologies. Audit firms will need to provide assurance on the reliability of the information users choose to access—including the systems producing it. Audit firms and other stakeholders in the capital markets will have to change significantly if they are to achieve this new business reporting model.

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<sup>7</sup>The report is available at [www.globalpublicpolicysymposium.com](http://www.globalpublicpolicysymposium.com).

## Other important accounting and auditing developments

### Business combinations

Companies negotiating acquisitions—and directors being asked to approve them—will want to follow the FASB's progress on its accounting for business combinations project, as it will significantly change current accounting practices. A final standard is expected to be released in mid-2007.

In addition to increasing the volume of transactions that are considered business combinations, the standard is expected to require companies to:

- Record assets acquired and liabilities assumed at fair value, with certain limited exceptions, which will cause a number of challenging valuation issues.
- Recognize assets and liabilities previously not recorded—for example, in-process research and development and acquired contingencies, even remote contingencies. Most contingencies will have to be accounted for at fair value in each subsequent reporting period, with the changes in fair value reflected in earnings.
- Expense transaction costs and restructuring charges.
- Record contingent consideration (earnouts) initially at fair value—with changes in fair value in future periods reflected in earnings.

There are also new ways of accounting for partial business combinations.

### Lease accounting

Companies commonly finance assets through lease transactions. A new project undertaken by standard setters will change the accounting for these transactions, possibly resulting in companies' recording on the balance sheet both the payments required to be made in connection with the lease and the related leasehold interest. This may prompt companies to consider alternative financing arrangements.

The FASB and International Accounting Standards Board, in July 2006, started a joint project on accounting for leases—considering accounting, recognition, and related transparency. The two boards plan to deliberate both lessee and lessor accounting, starting from scratch. The boards will release preliminary views for public comment in 2008.

This timetable notwithstanding, many, including the SEC, would like to see lessee accounting revised sooner rather than later. Accordingly, the FASB may address lessee accounting separately from and before lessor accounting. PricewaterhouseCoopers believes the new standards likely will cut back or eliminate operating lease accounting treatment, putting more or all lease transactions on the balance sheet.

Directors may want to discuss and consider these developments with management, with the objective of both understanding the potential effects of new standards on the company's business model and considering whether to provide input into the standard-setting process.

## Communications with audit committees at private companies

In December 2006, the AICPA issued Statement on Auditing Standards No. 114, *The Auditor's Communications With Those Charged With Governance*, effective for audits of financial statements of nonpublic companies for periods beginning on or after December 15, 2006. SAS 114 does not affect auditor communications for public companies, for which SAS 61 continues to apply.

SAS No. 114 requires certain information to be communicated to the audit committee or the board, including:

- An overview of the planned scope and timing of the audit
- Management representations requested by the auditor

Further, SAS 114 requires auditors to evaluate whether their two-way communication with the audit committee (or equivalent) has been adequate in the context of the auditors' assessing the risk of material misstatements and obtaining sufficient evidence.

# Appendix A

## The new executive compensation disclosures

The new disclosure rules require both narrative and tabular disclosures of executives' and directors' total compensation, including perquisites. In particular, the SEC is seeking greater transparency of compensation decisions and how they fit into a company's overall strategy.

The rules generally are effective for Form 8-K triggering events occurring on or after November 7, 2006, and for Form 10-K for fiscal years ending on or after December 15, 2006. A great deal of effort will be required to develop the new disclosures, and many functional areas will need to work together, including finance, human resources, and the general counsel.

### Who is covered by the new rules?

The new rules change who is included in the compensation disclosures and how companies make that determination. Companies will disclose compensation information for:

- The chief executive officer and the chief financial officer (or executives performing similar functions), regardless of the amount of their compensation. Thus, the CFO is automatically included even if his or her compensation is less than that of other executives.
- The next three most highly compensated executives who were serving as executive officers at the end of the previous fiscal year, unless an individual's total compensation is \$100,000 or less.

A company will determine who is most highly compensated based on the "total compensation" figure reported in the summary compensation table (discussed below), excluding the change in pension value and nonqualified deferred compensation earnings. As a result, the most highly compensated executives may change from year to year because of the broader definition of total compensation, which, in contrast to prior rules, now includes amounts other than salary and bonus. For that reason, the company may need to track total compensation for a broader group (say, eight to ten individuals), so it's prepared for subsequent executive changes.

### Compensation Discussion and Analysis

A new Compensation Discussion and Analysis (CD&A) will describe in narrative form compensation objectives, policies, and decisions for top executives. It is intended to put into perspective for investors the numbers and related information presented in the summary compensation and related supplemental tables. CD&A must answer six questions, as shown in the box.

#### CD&A questions

- What are the objectives of the company's compensation programs?
- What is the compensation program designed to reward?
- What is each element of compensation?
- Why does the company choose to pay each element?
- How does the company determine the amount (and, where applicable, the formula) for each element?
- How do each element and the company's decisions regarding that element fit into the company's overall compensation objectives and affect decisions regarding other elements?

Additionally, CD&A will address executives' stock option compensation, particularly the timing and dating of grants, and the methods a company uses to select the terms of awards, such as exercise prices.

Similar to Management's Discussion and Analysis, the SEC expects a company to tailor CD&A based on its specific facts and circumstances and not merely repeat information included elsewhere. CD&A also should identify material differences in compensation policies and decisions for individual executives, where appropriate.

### Filing status and certifications

CD&A will be “filed” with the SEC and thus is subject to the liabilities set out in the Securities Exchange Act of 1934. It also is covered by the CEO/CFO certifications required under the Sarbanes-Oxley Act, and its preparation is subject to a company’s disclosure controls and procedures. This is not a change in practice—the CEO/CFO certifications and rules on disclosure controls and procedures already cover information included in the proxy statement and incorporated by reference in the company’s Form 10-K. But with the extensive new disclosures, management will need to review, and possibly revamp, its disclosure controls and procedures to address the new requirements properly.

### Summary compensation table

The summary compensation table is the principal disclosure of executive compensation. The table should provide a clear, logical picture of total compensation and its corresponding elements for each executive, and facilitate comparability from company to company and across years. The box below shows the compensation elements the company will present, in columnar form.

The company has to provide narrative disclosure to help investors understand the information included in the table.

Implementation will be phased in, so a calendar-year-end company will provide disclosures for only 2006, increasing to two years in Year 2, and three years in Year 3.

Sample summary compensation table									
Name and principal position	Year	Salary (\$)	Bonus (\$)	Stock awards (\$)	Option awards <sup>8</sup> (\$)	Non-equity incentive plan compensation (\$)	Change in pension value and nonqualified deferred compensation earnings (\$)	All other compensation (\$)	Total compensation (\$)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)
Chief Executive Officer	— — —								
Chief Financial Officer	— — —								
Officer A	— — —								
Officer B	— — —								
Officer C	— — —								

<sup>8</sup>In December 2006, the SEC revised its guidance, requiring companies to disclose the compensation cost of such awards consistent with amounts recorded in the financial statements.

## Supplemental tables

There are six supplemental tables, shown in the box, which will report on the most recent fiscal year only, along with explanatory narrative disclosures.

### Supplemental tables

- Director compensation
- Grants of plan-based awards
- Outstanding equity awards at fiscal year end
- Option exercises and stock vested
- Pension benefits
- Nonqualified deferred compensation

Similar to the summary compensation table, each table involves significant disclosures, and management will need to assess whether the company has the appropriate expertise to value the various data elements.

Because the rules require that certain amounts be included in the summary compensation table and also in one of the supplemental tables, a concern has been raised about “double counting.” To alleviate this concern, companies can explain how amounts disclosed in more than one table relate to each other.

## Form 8-K

The rules modify Form 8-K requirements, so a company will disclose when it enters into a *material* agreement not made in the ordinary course of business. The revised rules should reduce the number of Form 8-K filings by limiting them to instances in which the agreements are material.

# Appendix B

## Internal control reporting and smaller companies

### Timelines for non-accelerated filers

In December 2006, the SEC adopted final rules to defer further the Section 404 reporting requirements for smaller public companies (i.e., non-accelerated filers, or companies with market capitalization under \$75 million). Under the rules:

- Management of a non-accelerated filer will report on its assessment of the effectiveness of internal control over financial reporting for fiscal years ending on or after December 15, 2007. This is an extension from fiscal years ending on or after July 15, 2007.
- Such companies will provide an auditor's report on internal control over financial reporting starting with fiscal years ending on or after December 15, 2008.

In addition, management's report included in a company's annual report in the period before an auditor's report is required (e.g., a Form 10-K for the year ending December 31, 2007) will be considered "furnished" rather than "filed" and will state that it has not been audited.

For final rules issued on the timing of internal control reporting for newly public companies, refer to Internal Control Reporting in this report.

### COSO report—*Internal Control over Financial Reporting – Guidance for Smaller Public Companies*

In June 2006, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued its final report, *Internal Control over Financial Reporting—Guidance for Smaller Public Companies*.<sup>9</sup> The guidance supplements, but does not replace or modify, COSO's 1992 *Internal Control—Integrated Framework*. The new report provides guidance to management of smaller companies on how to apply the Framework in establishing and maintaining effective internal control over financial reporting. It sets forth 20 basic principles underlying the five components of internal control: control environment, risk assessment, control activities, information and communication, and monitoring. And, while not designed explicitly for this purpose, it also may help management to assess internal control over financial reporting more efficiently.

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<sup>9</sup>Report is available at [www.coso.org](http://www.coso.org).

# Appendix C

## Developments affecting non-US private issuers

SEC and US stock exchange rules make increasingly less distinction between non-US and domestic issuers. Thus, although this section focuses on new rules of particular concern to non-US issuers, readers also should refer to other rules finalized in 2006 discussed elsewhere in this publication.

### Quantifying uncorrected errors—unique considerations for non-US private issuers

As discussed more fully under Financial Reporting Developments, the SEC has issued new guidance for quantifying financial statement errors.

The guidance is deemed to be an interpretation of US GAAP. So, although it technically does not apply to non-US companies' primary financial statements prepared on a basis of accounting other than US GAAP, the SEC strongly encourages companies to apply it to their primary financial statements. Any company contemplating having a reconciling item for errors not corrected in the primary financial statements, but corrected in the US GAAP reconciliation, would be expected to disclose explicitly and transparently the nature of the errors and why it believes it is appropriate not to correct the errors in the primary financial statements. Thus, it's highly unlikely any company would want to provide such disclosures in lieu of adjusting the primary financial statements. Accordingly, while not technically applicable, from a practical perspective PricewaterhouseCoopers believes SAB 108 normally would be applied to the primary non-US GAAP financial statements.

The SEC is addressing other issues, including potential conflicts between SAB 108 and Canadian requirements. Additional guidance is expected.

### Section 404—internal control over financial reporting

In August 2006, the SEC extended the Section 404 compliance date for non-US private issuers that have a worldwide market value of common equity held by nonaffiliates of between US \$75 million and US \$700 million—that is, accelerated filers, but not “large accelerated filers.” Such companies must provide an auditor's attestation report on internal control over financial reporting in their annual reports filed on Form 20-F or 40-F for fiscal years ending on or after July 15, 2007. Notably, this deferral did not have any impact on management's reporting under Section 404, which is required for fiscal years ending on or after July 15, 2006.

Refer to the full discussion of the final rules for non-accelerated filers in Appendix B.

### Changes to NYSE annual reporting requirements

The NYSE revised annual reporting requirements for non-US issuers. Under the new rules, companies are required to make the reports available on their website at the time the reports are filed with the SEC. Previous rules required non-US issuers to physically distribute to shareholders financial information that included a reconciliation to US GAAP. There should be no incremental burden for the vast majority of companies that currently post the entire 20-F to their website. Two additional conditions apply.

- Companies must post on their website a notice that, upon request, they will provide a hard copy of the complete audited financial statements free of charge.
- Companies must issue a press release indicating the 20-F has been filed with the SEC, providing the website address to obtain an electronic version, and stating that they will furnish a hard copy of the financial statements free of charge.

### Delisting and deregistering

In December 2006, the SEC again proposed rule changes to ease a non-US issuer's ability to deregister. The current rule prevents a company from terminating its registration unless it has fewer than 300 shareholders who are US residents—which makes it difficult for a company to cease its US regulatory reporting obligations, even if it has relatively little investor interest in its US-registered securities. Despite the existing hurdle for deregistration, the number of non-US companies registered with the SEC declined from 1,344 on December 31, 2001 to 1,236 on December 31, 2005, representing an 8% decline.

The repropounded rule easing deregistration by non-US issuers contains a new benchmark based on the average daily trading volume of the securities in the United States compared with the average trading volume in its primary trading market over a recent 12-month period. Other conditions apply, for example, that, with certain exceptions, the company did not, directly or indirectly, sell its securities in a registered transaction in the United States during the preceding 12 months.

The Commission is expected to adopt the final rules during the first half of 2007.



