Director Notes

Financial Reporting Challenges for 2012

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Reflecting the continued uncertainty and volatility of the global economic environment, this year's financial reporting challenges center around the identification, analysis, and disclosure of risks and uncertainties. To assist those responsible for preparing, certifying, reviewing and/or signing their companies' periodic reports in 2012, this report examines recent disclosure guidance issued by the Securities and Exchange Commission (SEC) and its staff, including guidance on the disclosure of cybersecurity threats and exposure to potential European sovereign debt defaults.

This disclosure guidance is the latest example of how, in this era of change, the SEC and its staff expect companies to apply a principles-based, holistic approach to analysis and disclosure of material risks and uncertainties of all kinds. First, we discuss the SEC's key messages for the fiscal 2011 Form 10-K, distilled from written pronouncements, comments by senior staff, and posted correspondence. We then discuss some key messages from the Public Company Accounting Oversight Board (PCAOB) aimed at independent auditors, which have reciprocal importance for audit committees. Broadly speaking, these messages—and the challenges they pose for public companies—are as follows:

- the need to identify and disclose material trends and uncertainties well before they harden into fact, and the continuing vitality, for this purpose, of the "two-pronged" test at the core of Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A);
- the need to make judgments on "materiality" from a qualitative as well as a quantitative perspective, as reinforced in 2011 by the courts;
- the need to provide investors with early and meaningful warning of material risks and uncertainties;
- the need to take a consistent and comprehensive approach to risk-related disclosures throughout the narrative and financial statement portions of periodic reports;
- the need to ensure that warnings of potential material litigation losses, and other material loss contingencies, evolve with the relevant facts and circumstances;
- the need to reassess the quality and reliability of long-standing assumptions and estimates used in the preparation of financial statements;
- the need to refresh disclosure controls and procedures (and, in the case of financial information, internal control over financial reporting) to adapt to changes in business, financial, legal and regulatory risks; and
- the need for audit committees to pay careful attention to "red flags" and to enhance their communications with the outside auditor.

No. DN-V4N4
FEBRUARY 2012

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First, we look at SEC interpretive releases outlining the agency's latest views on what constitutes adequate "early warning" disclosure during what has become a prolonged period of financial, political, and regulatory upheaval. These releases set forth the principles-based analytical template that guides staff comments and interpretive positions in a variety of contexts. We then highlight the staff's current financial reporting concerns, and close with some insights into the perspectives of the SEC Enforcement Division and the PCAOB on the appropriate role of the audit committee in overseeing corporate financial reporting, including proposed enhancements to the "two-way communication" between the audit committee and the outside auditor now mandated by U.S. generally accepted auditing standards.

Identifying Material Trends and Uncertainties and Providing Early and Meaningful Warnings about Risk

An excellent starting point for preparation of the fiscal 2011 Form 10-K is the SEC's February 2010 release entitled, "Commission Guidance Regarding Disclosure Related to Climate Change" (the Climate Change Release).[1] The Climate Change Release has much deeper significance for disclosure practices than what appears on the surface to be a limited (if somewhat controversial) focus on a single category of risks. In this release, the SEC reemphasized the importance of illuminating for investors, particularly through the MD&A, factors that are "reasonably likely to cause reported financial information not to be necessarily indicative of future operating performance or future financial condition."[2] These complex, forward-looking disclosure judgments require management to:

- consider financial, operational and other information **known** to the company, which means that management must have in place disclosure controls and procedures (as well as internal control over financial reporting or ICFR) that effectively and efficiently capture this information and bring it promptly to the attention of those within management who are charged with making key disclosure decisions on behalf of the company;
- based on the information thus collected, identify **known trends and uncertainties**; and
- evaluate whether these identified trends and uncertainties will have, or are **reasonably likely** to have, a **material** impact on a company's liquidity, capital resources or results of operations.

Thus embedded directly in MD&A's "known trends and uncertainties" disclosure requirement is one of the most challenging analyses prescribed by the federal securities laws—determining which items of predictive information might or might not be material in future periods when evaluated today in light of all relevant facts and circumstances.

The Supreme Court has repeatedly rejected the use of "bright-line" tests for gauging materiality, most recently in *Matrixx Initiatives, Inc. v. Siracusano*.[3] This unanimous March 2011 opinion held (in pertinent part) "that the materiality of adverse [drug] event reports cannot be reduced to a bright-line rule [i.e., that adverse drug reports are material only if there is a statistically significant number of such reports]."[4] In other words, statistical significance was just one of many factors the pharmaceutical company named in this suit should have considered in making disclosure decisions. As thus reaffirmed in *Matrixx*, a materiality determination must turn on whether "there is a substantial likelihood that the disclosure of the omitted [or misrepresented] fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[5] The bottom line for 2012 is this: In all situations where management is faced with a materiality determination—whether with respect to disclosure in the financial statements or the body of a Form 10-K, or anywhere else—remember that "[a]ny approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be over-inclusive or under-inclusive."[6]

The Two-Pronged Analysis

The Climate Change Release also reminds companies to apply the two-pronged analysis—first delineated in a 1989 MD&A interpretive release—in evaluating their obligation to disclose known trends, events or uncertainties.[7] Specifically, once management has identified a given trend, demand, commitment, event or uncertainty (and, as discussed below, management cannot bury its head in the sand to avoid such knowledge, particularly in the Internet era), it must make two assessments:

- Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that the contingency is not reasonably likely to occur, no disclosure is required.
- If management cannot make that determination, it must go on to evaluate objectively the consequences of the known trend, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required, unless management decides that a material effect on the company's financial condition or results of operation is not reasonably likely to occur.

The SEC expects management to cast a wide informational net and otherwise to establish appropriate disclosure controls and procedures not only to capture, but also to evaluate, the necessary information with a view toward possible disclosure. However, the SEC was careful to say that the breadth of the materiality analysis does not give management license to clutter the MD&A with "unnecessary detail or duplicative or uninformative disclosure that obscures the material information."[8]

In 2011, the U.S. Court of Appeals for the Second Circuit endorsed the SEC's two-step MD&A analysis in *Litwin v. Blackstone*.[9] Here, the Second Circuit overturned the lower court's grant of a motion to dismiss a private action brought under Sections 11 and 12(a)(2) of the Securities Act of 1933, as amended. Plaintiffs' complaint alleged material misstatements and omissions of material fact relating to Blackstone's 2007 IPO registration statement; specifically, that Blackstone had misapplied the materiality component of Item 303(a)'s "known trends and uncertainties" disclosure requirement.[10] The appellate court agreed with plaintiffs' construction of Item 303(a), citing SEC Staff Accounting Bulletin No. 99 with approval in emphasizing that both quantitative and qualitative factors must be considered when formulating materiality judgments, whether for the MD&A (under S-K Item 303) or in an antifraud context.[11] Notably, the court's materiality assessment focused on the significance of the alleged misstatements and omissions to each of two key accounting segments of the company, rejecting the company's argument that materiality must be evaluated from the perspective of the consolidated company rather than a particular segment. This is in keeping with the express requirement of S-K Item 303(a) that when "a discussion of segment information or of other subdivisions of the registrant's business would be appropriate to an understanding of such business, the [MD&A] discussion shall focus on each relevant, reportable segment or other subdivision of the business and on the registrant as a whole."

In the wake of *Matrixx* and *Litwin*, companies should eschew bright-line tests when making a difficult materiality judgment susceptible to future challenge by the SEC or a private plaintiff. Companies should be prepared to demonstrate, based on contemporaneous documentation, that all relevant qualitative and quantitative factors were evaluated in determining whether or not a "reasonable investor" would have considered a particular item of information to be important to informed investment decision-making.

Risk Factors

Closely intertwined with MD&A "known trends and uncertainties" disclosure is the need to provide effective risk factor disclosure. Comments from SEC staff—most recently by the Deputy Director of the Division of Corporation Finance at the November 2011 Practising Law Institute's Annual Institute on Securities Regulation (the 2011 PLI Annual Institute)—have made clear that risk factors must be reevaluated regularly to determine whether there has been any material change warranting disclosure, whether in the form of new or amended risk factors.[12]

Good risk factor disclosure is not just a matter of compliance with SEC line item disclosure requirements—it also affords companies substantial protection in private litigation under one prong of the identical safe harbors added to each of the Securities Act (Section 27A), and the Securities Exchange Act of 1934, as amended (Section 21E), by the Private Securities Litigation Reform Act of 1995 (PSLRA).[13] In order to meet PSLRA standards, risk factor language must be "meaningful" and must "accompany" any forward-looking statements contained in the MD&A and/or other narrative sections of periodic reports.[14]

To ensure that risk factors qualify as "meaningful" in light of evolving facts and circumstances, companies should bear in mind the lessons of a 2010 decision of the Second Circuit [noted] in speeches by senior SEC staff.[15] In *Slayton v. American Express Co.*,[16] the court ultimately ruled in favor of American Express and the other defendant-appellees on an appeal from the trial court's grant of a motion to dismiss in a securities fraud case, based on the "actual knowledge" prong of the PSLRA safe harbor.[17] However, the court criticized the risk factor invoked by the company, under the separate "meaningful cautionary statement" prong of the PSLRA, to protect a specific forward-looking statement set forth in the MD&A of its Form 10-Q for the first quarter of 2001. Specifically, the statement that the losses in a key subsidiary's high-yield debt investment portfolio, which had been large for the quarter being reported, "are expected to be substantially lower for the remainder of 2001." The risk factor read as follows: "[P]otential deterioration in the high yield sector ... could result in further losses in ... [the company's investment] portfolio." The court found this language to be so "vague" as to "verge on the mere boilerplate, essentially warning [merely] that 'if our [investment] portfolio deteriorates, then there will be losses in our portfolio.'"[18] The court's conclusion that this particular risk factor thus was not "meaningful" was "bolstered by the fact that the defendants' cautionary language remained the same even while the problem changed."[19]

Analysis and Disclosure of Liquidity Risks

Another SEC interpretive release is highly pertinent to preparation of the upcoming Form 10-K and addresses the adequacy of MD&A disclosure of liquidity and funding risks posed by various short-term borrowing practices in which both financial and nonfinancial companies engage (the MD&A Liquidity Release).[20] This release, which construed existing MD&A requirements, accompanied another SEC release proposing extensive new MD&A requirements for disclosure of intra-quarter fluctuations in short-term borrowings and the related risks and uncertainties.[21] To date, the SEC has not acted on the proposing release.[22]

Noting the proliferation of short-term financing techniques upon which many companies have come to rely in recent years, the MD&A Liquidity Release reaffirmed the importance of disclosure of "known trends or any known demands, commitments, events, or uncertainties that will result in, or that are reasonably likely to result in, the registrant's liquidity increasing or decreasing in any material way."[23] During the 2011 PLI Annual Institute, the deputy director of the Division of Corporation Finance emphasized the continuing importance of this release in guiding the staff review and comment process in 2012.

To illustrate the type of disclosure that should be made in the MD&A if material under a particular company's relevant facts and circumstances (applying the "total mix" test discussed above), the SEC listed several potentially material trends and uncertainties relating to liquidity that should be considered:

- difficulties accessing the debt markets;
- undue reliance on commercial paper or other short-term financing arrangements;
- maturity mismatches between borrowing sources and the assets funded by those sources;
- changes in borrowing terms requested by counterparties;
- changes in collateral valuation; and
- counterparty risk.

The SEC underscored what it considers to be management's *current* duty under Item 303—independent of its proposed short-term borrowing disclosure requirements—to explain any instances in which period-end liabilities reflected in the company's financial statements do not communicate adequately the risks and uncertainties attendant to material intra-quarter fluctuations in amounts borrowed.

Examples set forth in the MD&A Liquidity Release include repurchase agreements (a technique flagged in a March 2010 "Dear CFO" Letter issued by the Division of Corporation Finance staff), share-lending transactions and other off-balance sheet arrangements, or contractual repurchase obligations that may be accounted for as sales despite the seller's continuing involvement with the transferred assets.[24] Regardless of the appropriate accounting treatment or the existence of an obligation to disclose these transactions as material off-balance sheet arrangements or contractual obligations in the MD&A, further discussion and analysis may be necessary in the MD&A if management concludes that any of these transactions is "reasonably likely to result in the use of a material amount of cash or other liquid assets."[25] No matter how complex a specific financing arrangement might be, or whether its disclosure is expressly mandated by rule, the longstanding "principles-based" analysis of materiality in light of all relevant facts and circumstances should govern.[26]

Three areas of particularly helpful guidance in the MD&A Liquidity Release are discussed below.

- **Capital and Leverage Ratios** Companies often include capital and leverage ratios in their MD&As–for example, in descriptions of material debt covenants. First, if there are no regulatory requirements governing the use of such ratios, or management has modified the prescribed methodology for calculating a particular ratio, management should evaluate whether the ratio is a non-GAAP financial measure that brings into play the specific disclosures dictated by Item 10(e) of Regulation S-K.[27] (More on the staff's views regarding proper use of non-GAAP numbers below, in Part VI.F.). Regardless of whether the ratio is a non-GAAP financial measure, management should ensure that its disclosure in the MD&A relating to the measure "is accompanied by a clear explanation of the calculation methodology. [This explanation] … would need to clearly articulate the treatment of any inputs that are unusual, infrequent or nonrecurring, or that are otherwise adjusted so the ratio is calculated differently from directly comparable measures."[28] If the ratio differs from other ratios or measures generally used by a company's industry, management should consider its obligation to disclose any additional information needed to prevent the desired disclosure from being deemed misleading. "Finally, a registrant would need to consider its reasons for including the particular financial [or nonfinancial] measure, and should include disclosure clearly stating why the measure is useful to understanding its financial condition."[29]

- **Cash and Risk-Management Policies** The MD&A Liquidity Release also provides helpful tips on what the SEC expects to see in the MD&A concerning disclosure of cash- and risk-management policies relevant to an evaluation of a company's discussion and analysis of financial condition. This disclosure may be necessary, the SEC believes, to provide context for the material exposures identified in the MD&A (and thus ties directly into the staff's European Debt Exposure Guidance discussed in the next section).[30] A company that relies on a portfolio of cash and other investments as a material liquidity source, for example, should weigh whether to disclose the nature and composition (by asset type) of that portfolio, the existence of market, settlement or other risk exposure associated with the various asset types, and any limits or restrictions on access that might impair the company's ability to finance business operations. Banks could discuss policies and practices intended to satisfy banking agency guidance on managing liquidity and funding risk and, to the extent applicable, any internal policies and practices that might differ from such guidance.[31]
- **Contractual Obligations** Focusing on the MD&A's contractual obligations table, the SEC stressed the purpose of this sometimes overlooked disclosure requirement: to provide a "meaningful snapshot of cash requirements arising from contractual payment obligations."[32] Despite calls for bright-line guidance with respect to the appropriate disclosure methodology for such diverse items as obligations under repurchase agreements, tax liabilities, interest payments on debt, pension funding obligations, synthetic leases, purchase obligations and off-balance sheet obligations, the SEC reaffirmed its preference for a flexible, "facts-and-circumstances" approach. Each company "should develop a presentation method that is clear, understandable and appropriately reflects the categories of obligations that are meaningful in light of its capital structure and business[,]" and highlight any changes in that method to enable investors to make period-to-period comparisons. Where necessary to enhance investor understanding of the timing and amount of the specified contractual obligations, companies should add footnotes or additional narrative to explain the tabular data. The SEC suggested, for example, that a company might consider separating amounts in the table into "on-" and "off-" balance sheet, particularly where such a distinction helps tie the information to disclosure in the MD&A and financial statements. [33]

New Staff Disclosure Guidance for 2012: Risks Relating to European Debt Exposures

In January 2012, the Division of Corporation Finance published a Disclosure Guidance Topic entitled, "European Sovereign Debt Exposures" (the European Debt Exposure Guidance), which outlines the staff's expectations regarding appropriate disclosure of material risks arising from the ongoing European debt crisis.[34] Although focused primarily on disclosure by banks and other financial institutions of risks associated with investment in the sovereign debt of some of the more economically distressed nations within the European Union, the guidance explicitly extends to private-sector as well as public-sector debt exposure. Senior Division of Corporation Finance accounting staff have emphasized that, some, if not all of the same considerations may be highly relevant to nonfinancial companies, depending on the magnitude of various risks associated with conducting business in Europe—or elsewhere at any given time—and how those risks are managed.[35]

The guidance was motivated by the staff's concern that companies were presenting disclosures that were inconsistent, both in substance and in presentation, with respect to the nature and extent of exposure to European sovereign debt. The staff noted, for example, that some companies disclosed only aggregate exposure to sovereign debt, corporate debt and/or retail debt (e.g., loans or accounts receivable) on a multi-country basis, while others quantified their exposure by "each country of concern" and/or specific debt category. Some companies disclosed only net debt default exposures; others disclosed both gross and net exposures. Finally, some companies disclosed the effects of credit default contractual protection relating to outstanding debt based on notional values, others based on fair market values. During 2011, staff comment letters requested that companies disclose: (1) gross exposure to debt issued by sovereigns, financial institutions, and nonfinancial corporations, shown separately by country; (2) quantitative information explaining how gross exposures are hedged; and (3) the circumstances under which losses may not be covered by purchased credit protection. Despite "incremental improvements" observed in response to these comments, the staff determined that investors would benefit from further division guidance that would assist companies in assessing what information about exposure to European debt they should consider disclosing under various line item requirements that might apply.

According to the staff, a company's analysis should begin with consideration of the need for disclosure pursuant to several potentially applicable SEC line items:

- the MD&A's "known trends or uncertainties" element codified in S-K Item 303;
- for bank holding companies, Industry Guide 3 calling for disclosure of "cross-border outstandings to borrowers in each foreign country where the exposures exceed 1 percent of total assets and further information (including certain tabular disclosure) where current conditions in a foreign country give rise to liquidity problems which are expected to have a material impact on the timely repayment of principal or interest on the country's private or public sector debt";
- risk factors under S-K Item 503(c); and
- a quantitative and qualitative assessment of market risk under S-K Item 305. Although not highlighted, materiality is obviously an important component of analysis under all of these requirements. With respect to risk factors and market risks in particular, the staff reminded management that generic boilerplate risk disclosures are insufficient.

The staff did not identify the countries to which the guidance might apply. Instead, the staff diplomatically directed companies to determine for themselves those countries "experiencing significant economic, fiscal and/or political strains such that the likelihood of default would be higher than would be anticipated when such factors do not exist." Because the staff expects that the countries covered by the recommended analysis would vary as time goes by, "the disclosures should be sufficiently flexible to capture those risks as they change over time" and should explain the basis for selecting individual countries. Presumably, depending on economic conditions, the guidance is relevant to evaluation of debt exposures in countries not just in Europe, but anywhere in the world.

The guidance goes on to define a "principles-based" analytical framework for determining disclosable "gross unfunded exposure" to European debt. The framework contemplates disclosure on a country-by-country basis, segregated by type of default exposure and financial statement category. Companies also are urged to consider separate disclosure of "gross unfunded commitments" and, finally, "net funded exposure" buttressed by information on corresponding hedges.

Although this guidance does not indicate precisely where in periodic reports the recommended disclosures should appear, it provides a detailed list of considerations for companies trying to decide what disclosure is relevant and appropriate for their particular facts:

- **Gross funded exposure** What is the basis for selecting, for disclosure purposes, the countries to which the company is exposed, and the domicile of the exposure? What are the exposures by type of counterparty, broken out, for example, by sovereign and nonsovereign (with separate disclosure about financial and nonfinancial institutions to the extent material)? What are the exposures by categories of debt, including (but presumably not limited to) loans and leases, held-to-maturity securities, available-for-sale securities, marketable securities, derivative assets, credit default contracts sold, and other financial exposures?

  Note: Other than to recognize that different types of debt will be classified differently for financial statement presentation purposes, and that most will require fair value measurements (whether or not the debt is deemed impaired), the staff offers no real insight into the proper accounting treatment of the various types of debt identified in this guidance or, for that matter, of any related hedging arrangements such as credit default swaps and other derivatives. Companies should keep in mind, however, that the SEC expects the MD&A (and the S-K 305 market risk disclosure, if separate) to explain the significance of the numbers reflected in the financial statements—many of which, particularly in the case of fair value measurements, are the product of management assumptions regarding future events and estimates that themselves are highly susceptible to change, and thus are candidates for more rigorous "critical accounting estimate" disclosure (as discussed more fully in the MD&A Liquidity Release and its predecessor, the 2003 MD&A Interpretive Release).

- **Unfunded commitments** What are the amounts of unfunded commitments by type of counterparty and by country? What are the key terms and potential limitations of the counterparty's ability to draw down on the facilities?

- **Total gross exposure (both funded and unfunded)** What is the total gross exposure, obtained by subtotaling the effect of gross funded exposure and total unfunded exposure at the balance sheet date, separated into type of counterparty and country? The staff notes that companies may include "additional key details," such as maturity information, via "appropriate footnote disclosure."

- **Effects of credit default protection in arriving at net exposure** What are the effects of credit default protection purchased, separately by counterparty and country? What are the fair value and notional value amounts of such protection? What is the nature of the payout or trigger (credit) events under the purchased contracts? From what types of counterparties was the credit protection purchased, and what are the indications of counterparties' credit quality? Does the credit default protection purchased have a shorter maturity date than the bond or other exposure against which the protection was purchased? (If so, the staff suggests that companies consider "clarifying disclosure" about this fact and the risks of mismatched maturities.)
- **Other risk management disclosures** How is management monitoring and/or mitigating exposure to the country or countries identified, including any stress testing performed? What are indirect exposures, and how are they being managed and/or mitigated? What current developments relating to countries selected for analysis, such as rating downgrades, financial relief plans for affected countries and widening credit spreads, could impact the company's financial condition, operational results, liquidity or capital resources?
- **Significant post-reporting date events** Have there been any significant developments since the reporting date affecting the reported amounts? These developments might include, for a particular country or issuer, a credit rating downgrade, widening credit spreads, or the provision of financial relief.

New Staff Disclosure Guidance for 2012: Cybersecurity Risks

In October 2011, the Division of Corporation Finance published disclosure guidance regarding cybersecurity risks and cyber incidents (the Cybersecurity Guidance).[36] The impetus appears to have been a combination of companies' increasing dependence on digital technologies in conducting business operations, recent media reports of "more frequent and severe cyber incidents," debate within the legal and accounting communities with respect to registrant disclosure obligations in this area, and a Congressional letter of inquiry addressed to the SEC chairman.[37] In outlining an analytical framework for companies to use, the staff was careful to stress that it is not requiring disclosure of information that could provide a "'roadmap' for those who seek to infiltrate a registrant's security network."

The significance of the Cybersecurity Guidance extends far beyond the category of risk singled out for discussion and analysis. The SEC staff explicitly acknowledged that there is no specific line item disclosure requirement relating to cybersecurity risks and cyber incidents. However, taking a principles-based approach, the staff pointed out a number of existing sources of disclosure obligations that potentially could apply. These include a range of line items, as well as the general antifraud provisions of both the Securities Act and the Exchange Act that require disclosure of any additional facts necessary to render other mandatory disclosures, in light of all relevant circumstances, not materially misleading. The broad message of the Cybersecurity Guidance is that discussion of risk should not be corralled exclusively within the risk factor section of periodic reports, but should be considered holistically as it affects such required disclosures as the description of business, legal proceedings, the MD&A, the financial statements, the effectiveness of a company's disclosure controls and procedures, and, where financial information is involved, its ICFR.

The Cybersecurity Guidance encouraged companies to review, on an ongoing and comprehensive basis, the adequacy of their disclosures relating to cybersecurity risks and incidents in the following manner:

- **Risk factors** Item 503(c) of Regulation S-K requires companies to disclose the risks of cyber incidents if such matters rise to the level of disclosable risk factors (i.e., are among the most significant factors that make an investment in the company speculative or risky). To determine whether risk factor disclosure is required, companies should take into account "all available relevant information," including: the existence, frequency, and severity of prior cyber incidents; the probability of future incidents; the quantitative and qualitative magnitude of the consequences should the risks materialize (e.g., misappropriation of sensitive information, corruption of data or disruption of operations); and the adequacy of preventative measures. If a company determines that risk factor disclosure must be provided, the company must describe adequately the nature of the material risks and specify how each risk affects the company (as opposed to providing generic or "boilerplate" disclosure).

Examples of appropriate cyber risk-related disclosures, depending on the company's particular facts and circumstances, include:

- a discussion of aspects of the company's business or operations that give rise to material cybersecurity risks and the potential costs and other consequences;
- to the extent the company outsources functions that have material cybersecurity risks, a description of those functions and an explanation of how the company addresses these risks (two obvious examples are payroll and employee benefit plan administration);
- a description of cyber incidents that the company has experienced that are material – either individually or in the aggregate – along with the costs and other consequences;
- disclosure of risks related to cyber incidents that may remain undetected for an extended period; and
- a description of relevant insurance coverage.

In the event a significant risk has already materialized, say, a company actually experienced a material cyber attack, the staff cautioned that it would not be sufficient merely to state that such a risk may occur. Instead, as the Cybersecurity Guidance points out, the company may have to put this risk in context by discussing "the occurrence of the specific attack and its known and potential costs and consequences." This is consistent with the Second Circuit's observation in *Slayton* (discussed above) that risk factors must be reevaluated and, where necessary, revised as the underlying facts and circumstances change. In short, stating that a significant risk may materialize when it already has might well be materially misleading.

- **MD&A** Companies should address cybersecurity risks and incidents in their MD&A "if the costs or other consequences associated with one or more known incidents or the risk of potential incidents represent a material event, trend, or uncertainty that is reasonably likely to have a material effect on … results of operations, liquidity, or financial condition or would cause reported financial information not to be necessarily indicative of future operating results or financial condition." To illustrate, the staff offers the example of a cyber theft of important intellectual property, the effects of which are "reasonably likely to be material." In this situation, the company should describe the stolen property and the effect of the cyber attack on its results of operations, liquidity and financial condition, and discuss whether the attack would cause reported financial information not to be indicative of future operating results or financial condition. In addition, if management believes that it is reasonably likely that the attack will result in reduced revenues, and/or an increase in cybersecurity protection costs (including costs related to litigation), the MD&A should discuss these possible outcomes, including the amount and duration of the expected costs if deemed material. Even if such a cyber attack failed, companies should disclose and explain any material increases in cybersecurity protection expenditures.
- **Description of business** Where one or more cyber incidents have a material effect on a company's products, services, customer or supplier relationships, or competitive conditions, the company should provide appropriate disclosure in this section of the Form 10-K (or report material changes in a Form 10-Q). In this connection, companies should consider the impact on their reportable segments. "As an example, if a registrant has a new product in development and learns of a cyber incident that could materially impair its future viability, the registrant should discuss the incident and the potential impact to the extent material."
- **Legal proceedings** Companies should evaluate the need for disclosure of a material pending legal proceeding arising from a cyber incident, such as the theft of "a significant amount of [a company's] customer information." If such an incident results in material litigation against the company or any of its subsidiaries, the company should disclose the name of the court in which the case is pending, the date it was instituted, the principal parties, a description of the underlying facts, and the relief sought.
- **Financial statements** The staff reminded companies that "[c]ybersecurity risks and cyber incidents may have a broad impact on a registrant's financial statements, depending on the nature and severity of the potential or actual incident." Before a cyber incident occurs, a company may incur substantial preventative costs relating to internal use software that would have to be capitalized under US GAAP. During and after such an incident, the company should consider the implications of the following for its financial statements: (1) the costs of any customer incentives necessary to prevent the loss of business relationships; (2) accrual and/or disclosure of material loss contingencies (losses and potential losses from asserted and unasserted claims for breach of contract, product warranties, product recall and replacement and indemnification of counterparty losses); (3) diminished future cash flows requiring consideration of impairment of certain assets such as goodwill, customer-related intangible assets, trademarks, capitalized software or other long-lived assets associated with hardware or software, and inventory; and (4) if the cyber incident is discovered after the balance sheet date but before the financial statements are issued, the need for disclosure as a material recognized or nonrecognized subsequent event. If the incident is a material nonrecognized subsequent event, the financial statements should disclose the nature of the incident and the estimated financial effect, or a statement that no estimate can be made.

- **Disclosure controls and procedures** Companies often rely heavily on automated systems to collect, store and process information relating to critical business and administrative functions. Because companies are required to disclose conclusions as to the effectiveness of their disclosure controls and procedures, they should assess the "extent to which cyber incidents pose a threat to their ability to record, process, summarize, and report information that is required to be disclosed in Commission filings, … [and] also consider whether there are any deficiencies in … disclosure controls and procedures that would render them ineffective." The example given in the Cybersecurity Guidance is as follows: "[I]f it is reasonably possible that information would not be recorded properly due to a cyber incident affecting a registrant's information systems, a registrant may conclude that its disclosure controls and procedures are ineffective." Although not mentioned in the guidance, companies also should consider the integrity of IT functions that are part of or affect the operation of internal accounting controls–including any that are used by third-party providers to whom critical administrative functions have been outsourced (e.g., employee benefit plan administration, payroll, etc.)–in evaluating ICFR effectiveness.

A Recurring Area of Staff Comment: Disclosure of Material Loss Contingencies

Although the Financial Accounting Standards Board (FASB) has postponed indefinitely its controversial proposal to change the accounting treatment of loss contingencies, companies should not yet breathe a sigh of relief. If anything, the FASB's decision to stay its hand, at least temporarily, has increased the pressure on both preparers and auditors of financial statements to demonstrate that they are complying with what the FASB and the SEC have emphasized are existing GAAP requirements regarding material loss contingencies[38] (primarily ASC Subtopic 450-20, formerly known as FAS 5).[39] Senior staff members of both the SEC and FASB warned throughout 2011 that they are reviewing "FAS 5" compliance in periodic reports with even greater rigor than before.[40]

Through the inspection process, the PCAOB staff have likewise been evaluating whether the registered public accounting firms serving as outside auditors of public companies are meeting their obligations when auditing loss contingencies, disclosures and related items. In a December 2010 PCAOB Staff Audit Practice Alert,[41] the PCAOB staff cautioned registered public accounting firms that the audit risks that existed in late 2008 regarding loss contingencies and guarantees (among other areas) had persisted to this day, and that auditors should drill down on management estimates and judgments and communicate their views on these and other matters to the client's audit committee.[42] If the PCAOB staff decides that a particular audit engagement selected for examination during the inspection process is materially deficient—for example, if the staff concludes that the auditor did not collect sufficient evidence to support management's estimates or assertion of an inability to make a reasonable estimate, or did not display the requisite professional skepticism in challenging management's judgment that a potentially material loss is not "reasonably possible"—the result can be an inspection report that outlines potentially material accounting errors that ultimately could lead to a restatement of the particular company's financial statements and, in the most serious cases, a referral to the SEC for further investigation.[43]

Companies are required under ASC Subtopic 450-20 to accrue an estimated loss for a litigation loss contingency if information available before the financial statements are issued indicates that it is both probable that a liability has been incurred as of the date of the financial statements, and the amount of loss (or a range) can be reasonably estimated. Even where no accrual is necessary because a loss is not considered "probable" and/or cannot be reasonably estimated, a company must disclose the loss contingency in the footnotes to its financial statements if there is at least a "reasonable possibility"—defined as "more than a remote" likelihood—that a loss or an additional loss (i.e., an amount above that previously accrued) has been incurred. This disclosure must address the nature of the contingency and either give an estimate of the loss or range of losses, if material, or state that such an estimate cannot be made. Since at least 2006, the SEC's Division of Corporation Finance has emphasized the importance of an MD&A discussion of material preaccrual loss contingencies as a "known trend or uncertainty."[44]

As reflected in SEC staff speeches throughout 2010[45] and reaffirmed at conferences in 2011,[46] as well as in a "Dear CFO" Letter issued in October 2010[47] and comment letters issued in 2011 and 2010, the SEC staff is taking aim at such practices as suddenly revealing an accrual in the financial statement footnotes without any advance warning at the "reasonably possible" stage in the MD&A and/or financial statements' loss contingencies footnote—whether in the form of an estimated loss or range of losses, or a representation that such losses are not reasonably estimable accompanied by a meaningful qualitative discussion.[48]

Tips for Disclosure of Loss Contingencies in 2012

Given the SEC staff's views, and in the interests of preventing further FASB action, companies preparing periodic reports should take the following recurring areas of SEC staff comment into account, recognizing that the staff may insist on amendments to previously filed reports in the event of perceived noncompliance:

The staff expects to see a more thoughtful analytical approach taken in the MD&A (and in the loss contingencies footnote to the financial statements) than in the "factual" S-K Item 103 (legal proceedings) disclosure, and will be looking for inconsistencies between and among the MD&A, the litigation section, the risk factors and the financial statement footnotes. As discussed above, the reviewing staff also will be looking for material inconsistencies between the content of SEC-filed documents and other, less formal corporate communications, such as web-posted transcripts of earnings calls and earnings releases.

If management cannot estimate the amount of loss or a range of losses for a material loss contingency deemed "reasonably possible" (or a group of similar loss contingencies that may be aggregated, as discussed below), it should so disclose and provide a qualitative explanation of the relevant facts and circumstances that go beyond the predominantly factual discussion required in the section of Item 3 of Form 10-K, which calls for disclosure of the information required by S-K Item 103. The staff has been challenging statements that management cannot estimate a reasonably possible loss with "precision" or "confidence" – first, on the ground that qualifying terms of this nature are not permitted under ASC Subtopic 450-20; and second, to require support for the assertion that management is unable to estimate the reasonably possible loss (or range of reasonably possible losses).

If management determines that reasonably possible losses in excess of amounts already accrued (as probable) are immaterial, it should disclose this determination and explain the underlying reasoning. In this regard, the staff has emphasized that materiality must be assessed in light of all of the issuer's financial statements – the balance sheet, the income statement and the cash flows statement.

Potential recoveries from insurance or other indemnification arrangements should not be "netted out" from a disclosed estimate (or range of estimates) of a "reasonably possible" loss contingency (or contingencies, if aggregated), unless the company provides both the gross and net estimated amounts and additional information on the company's policy for recognizing third-party recoveries, the nature and scope of any uncertainties relating to such recoveries, and the classification of recoveries in the company's income statement.

Management should reevaluate the status of pending or threatened litigation (including governmental investigations that may lead to civil or criminal enforcement action) on a regular basis, in light of the staff's view that, as a given matter progresses, the available information on potential losses both expands and sharpens, and therefore may trigger one or more of an MD&A, financial statement footnote and/or risk factor disclosure obligation. Ultimately, a change in the pertinent facts and circumstances could allow quantification of an estimate of reasonably possible losses that previously could not be made, require an accrual because the "probable loss" threshold has been crossed, or require an increase in an accrued amount because the reasonable estimate of the probable loss has increased. In each instance, updated disclosure will be required and an explanation of the reason for the change may preempt potential staff comments.

Companies may aggregate estimated amounts for similar loss contingencies, but should be careful not to use aggregation to obscure material information relating to a particular contingency and avoid discussion and analysis of its implications for the particular company. This position has been taken by the staff in response to concerns that case-specific disclosures may be prejudicial to the company's litigation defense and even potentially outcome-determinative. It does not, however, solve the problem for a company that has a distinct material case that cannot be aggregated with others.

Companies should be aware that the staff may request disclosure of management's policy on accounting for legal fees, if material (companies have a choice of accruing the fees as incurred or as part of the broader accrual for the loss contingency).

Senior Division of Corporation Finance officials recently observed that the staff had seen "significant improvement" in the quality of loss contingencies disclosure provided by large financial institutions.[49] While acknowledging that staff comments have largely focused on these institutions, the staff indicated that disclosure by other registrants " has not been stellar."[50]

Other Key Areas of Focus for the Upcoming Form 10-K

Senior SEC staff members have expressed concern about the difficulty of gauging—and of communicating fully and fairly to investors in periodic reports—the impact of persistent economic uncertainty and heightened global risk on the integrity of a financial reporting system driven increasingly by forward-looking fair value accounting measurements.

Because such measurements are highly sensitive to the least variation in relevant assumptions and estimates, corporate management are being called upon to reassess the quality and reliability of long-standing assumptions and estimates with respect to the future performance not only of their own companies and industries, but also of the global marketplace within which many now operate. To illustrate, the staff has warned companies in the process of quantifying future funding obligations for pension plans and other post-retirement employee benefits that they must carefully evaluate the significance of the "double whammy" they now face—a protracted period of low interest rates and a decline in the value of plan investment assets, resulting in mounting net unfunded pension and other post-employment benefit obligations on corporate balance sheets.[51] In particular, the unprecedented downgrade of U.S. government debt by one credit rating agency last August has caused managers to reevaluate continued reliance on U.S. Treasury yields as a leading benchmark for risk-free rates of return used to calculate the fair value of many pension plan investments. The quality of disclosure regarding how management plans to fulfill these obligations as future minimum statutory funding requirements kick in, along with the potential material effects on liquidity disclosed in the MD&A, will be a special focus of staff comments in 2012.

Likewise, the PCAOB has expressed serious concern regarding the implications of continued economic volatility around the world for the independent integrated audit of corporate financial statements and ICFR. This concern prompted the publication in December 2011 of Staff Audit Practice Alert No. 9, designed to assist auditors in identifying "matters related to the current economic environment that might affect the risk of material misstatement [in the financial statements] and, therefore, require additional audit attention."[52] The alert highlights the new PCAOB audit risk assessment auditing standards (Nos. 8 through 15), which became effective for the 2011 audit of calendar-year reporting companies. It also calls attention to Staff Audit Practice Alert No. 8, which addresses fraud risks associated with audits of operations in China and other emerging markets, especially when a company is faced with challenging economic conditions.

More broadly, Staff Audit Practice Alert No. 9 cautions auditors that heightened fraud risk factors exist whenever and wherever financial stability or profitability is threatened by poor economic conditions, excessive pressure exists for management to meet analyst or other third-party expectations or there is excessive pressure on operating personnel (especially in remote locations) to meet sales or profitability incentive goals. Audit committees should expect to see auditors paying careful attention and applying professional skepticism in the following four areas:

- the impact of changing economic conditions near year-end on the original audit plan, including the need to reevaluate previously established levels of materiality and tolerable misstatement, and to sharpen risk assessment procedures and consider external information;
- inconsistency in assumptions and other signs of possible management bias when auditing fair value measurements and estimates and, if found, the implications of such bias for the auditor's report on internal control over financial reporting;
- a company's ability to continue to operate as a going concern for a reasonable period of time (not to exceed one year beyond the date of the financial statements being audited) and, where substantial doubt exists, the need to consider the adequacy of support for management's ability to implement its plans to mitigate adverse conditions; and
- increased risks relating to omitted, incomplete or inaccurate financial statement disclosures with respect to loss contingencies (and other risks and uncertainties where an estimate has not yet been disclosed), concentrations of credit risk and liquidity concerns, and to take into account qualitative considerations in evaluating these types of disclosures.

A notable risk highlighted in Staff Audit Practice Alert No. 9 is pertinent to companies that may find themselves under the SEC staff's microscope due to material European debt exposure (as discussed above). According to the PCAOB staff, "in the current economic environment, a company with substantial direct or indirect sovereign debt exposure may be motivated to not consider all relevant market information when determining a fair value measurement or enter into off-balance sheet arrangements that fail to be appropriately accounted for or disclosed."[53] So, for example, expect probing auditor questions if your company has significant direct or indirect exposure to Europe's current economic troubles (e.g., a large amount of delinquent accounts receivable if your company conducts significant business with European governmental or semi-governmental customers now having difficulty paying for the company's goods or services).

Other areas of special concern flagged by the SEC and PCAOB staff in anticipation of the upcoming Form 10-K filing season are discussed in greater detail below.

Use of Third-Party Pricing Services in Making Fair Value Measurements

Both the SEC and PCAOB staff took the opportunity at the December 2011 AICPA Conference to urge companies and independent auditors to be cautious with respect to the reliability of information obtained from third-party pricing services that may be used by corporate management to develop fair value estimates and financial statement disclosures relating to financial instruments, including those held by many corporate retirement plans. Estimating the fair value of relatively illiquid securities, including the threshold determination whether to classify them either as "Level 2" (valuation using other significant observable inputs, such as market prices for similar securities) or "Level 3" (valuation using significant unobservable inputs, such as proprietary models), may demand substantial management judgment. Management cannot outsource these complex judgments to third-party services consistent with U.S. GAAP; to the contrary, management must understand the models applied by such services, along with the significant inputs and assumptions made in arriving at specific valuations. To illustrate what likely would fail to pass GAAP muster, the SEC staff observed that, "[i]f the pricing service only provides a price for a given CUSIP with no information about the models or assumptions used to price it [the security], management may not have enough information to assess the appropriateness of that price to determine whether it is in conformity with GAAP."[54]

SEC staff comments in this area will center on whether management has complied with applicable U.S. GAAP (ASC Topic 820), and whether management has designed and maintains an "appropriate" ICFR within the meaning of Section 404 of the Sarbanes-Oxley Act of 2002, and "accurate and reasonably detailed books and records" for purposes of Section 13(b)(2) of the Exchange Act.[55] Rather than wait for the staff's comments, management should ask itself the following questions regarding its use of third-party pricing data in preparing the company's financial statements:

- Do we have sufficient information about the values provided by pricing services to know that we're complying with US GAAP?
- Have we adequately considered the judgments that have been made by third parties in order to be comfortable with our responsibility for the reasonableness of such judgments?
- Do we have a sufficient understanding of the sources of information and the processes used to develop it to identify risks to reliable financial reporting?
- Have we identified, documented and tested controls to adequately assess the risks to reliable financial reporting?

Independent auditors likewise would benefit from asking these questions when conducting the integrated audit of a company's financial statements and ICFR (more guidance on ICFR responsibilities of management in this area below). Picking up on this theme during the 2011 AICPA Conference, the PCAOB's Chief Auditor reminded outside auditors that the PCAOB inspection staff will be closely monitoring whether registered public accounting firms have maintained the proper degree of professional skepticism in situations involving management's use of third-party pricing services. This is not a new priority for the PCAOB—a September 2010 PCAOB inspection report was critical of auditors failing to evaluate whether management's fair value measurements were the product of appropriate valuation methodology, and in testing ICFR over such measurements.[56]

Income Tax Disclosure Issues

As the Division stated in its FRM: "Registrants should consider discussing and analyzing the tax implications related to material transactions, trends, and other important items impacting their business as disclosed elsewhere in the MD&A."[57] Specific areas of focus, some of which were underscored by the staff at various conferences throughout 2011, include the following:

- Companies should consider the need for MD&A and/or financial statement footnote disclosure in the event tax rate reconciling items result, for example, from a significant change in assumptions involving an unrecognized tax benefit or a different final resolution of any dispute related to that benefit. If uncertain tax positions constitute a critical accounting estimate, the MD&A should address why the assumptions were changed, or why the actual resolution differed from management's assumption.[58]
- In light of continued economic uncertainty within and outside the United States–particularly within the European Union–companies with substantial international operations should evaluate, with a view to possible MD&A disclosure, the validity of the assumption often made that earnings of a foreign subsidiary will not be repatriated (meaning that they will not be subject to U.S. income tax, resulting in a tax rate reconciliation item). The staff has recommended that in appropriate cases–for example, when a company's disclosures reflect a significant amount of foreign earnings for which there has been little or no tax provision–the MD&A should explain, as a material trend or uncertainty, that cash resources located offshore in a foreign subsidiary or subsidiaries may not be available to the US parent company (either in whole or in part) in the event of a liquidity crunch, at least without incurring a significant tax liability.[59]

- Valuation allowance assessment for deferred tax assets remains a staff "hot button" issue. For example, the staff cautioned that "[f]orming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in recent years."[60] The staff continues to urge companies to consider including disclosure in the MD&A (and financial statement footnotes) if a material increase in the valuation allowance is reasonably likely to occur.[61] Note also that the PCAOB considers this to be a high-risk area for outside auditors: "[E]stimates made by issuers regarding the recoverability of deferred tax assets as well as the outcome of uncertain tax positions might require significant management judgment, which increases the risk of material misstatement, particularly in times of economic distress."[62]

Goodwill Impairment

Goodwill impairment remains a favorite SEC staff candidate for critical accounting estimate treatment, particularly given the extreme sensitivity of fair value-focused goodwill impairment testing to adverse economic conditions.[63] The SEC staff announced during the 2011 AICPA Conference that it does not expect FASB's recent revision of the relevant U.S. GAAP standard (ASU No. 2011-8, Testing Goodwill for Impairment, amending ASC Topic 350), to have a material effect on the outcome of goodwill impairment testing.[64] Because early adoption of the revised standard is permissible, the staff apparently expects some companies to use this option to make an initial, qualitative assessment of whether it is more likely than not that a reporting unit's fair value is less than its carrying amount before proceeding to apply the familiar two-step impairment analysis. Some accountants have referred to this preliminary qualitative assessment as "Step Zero."[65] The staff warned that it may issue comments if a company uses a qualitative assessment to avoid impairment testing on units that may be "at risk" for impairment (as explained below).

Note: Current U.S. GAAP requires companies to use a two-part test to determine whether goodwill is impaired at least once a year, and more frequently if certain events or circumstances indicate that goodwill may be impaired. Step One consists of determining whether the fair value of a "reporting unit" (defined by reference to the company's US GAAP-prescribed operating segments, a topic which is addressed in the next section) is less than its carrying amount, including goodwill. If so, go on to Step Two; if not, there is no impairment. Under Step Two, the company must measure the amount of impairment loss to be recorded – this is accomplished by comparing the "implied fair value" (calculated pursuant to a specified methodology) of the reporting unit's goodwill with the carrying amount of that goodwill.

The SEC staff expects companies to provide early warning in the MD&A—as a "known trend or uncertainty"—of the possibility that one or more reporting units are "at risk" of failing Step One of the impairment test if the actual impact of impairment would be material. The optional qualitative screen just introduced does not supplant the two-step analysis, but could be applied to preclude application of that analysis if an entity "passes" the threshold qualitative test. As noted, the staff will be on the lookout during the review process for indications that a company has improperly applied the qualitative test to evade traditional impairment testing. In particular, the staff has indicated that companies in this situation should disclose (preferably in the context of discussing treatment of goodwill as a critical accounting estimate for MD&A disclosure purposes, given the significant use of estimates and assumptions associated with fair value measurements): (1) the percentage by which the fair value of the reporting unit exceeded the carrying value as of the latest impairment testing date; (2) the amount of goodwill allocated to the unit; (3) a description of the methods and key assumptions used by management, and how those assumptions were determined; (4) a discussion of the degree of uncertainty associated with the key assumptions; and (5) a description of the potential events and/or changes in circumstances that reasonably could be expected to affect negatively the key assumptions.[66]

A 2010 PCAOB report on audit risks and challenges identified by its staff in conducting inspections of registered public accounting firms over a two-year period of the recent economic crisis (2007–2009) found that some audit firms applied insufficient skepticism to management judgments that goodwill and other intangible assets did not need to be tested more frequently than annually despite the presence of incipient impairment indicators.[67] Such indicators include "recent declines in issuer stock prices or reduced estimates of future revenue in situations where such declines or reductions appeared to be potentially significant to issuers' most recent impairment analyses."[68] The PCAOB report also found failures by some accounting firms to evaluate, as required, the reasonableness of certain significant assumptions used by management in impairment assessments.

In light of this report's findings, the PCAOB recommended that audit committees of public companies consider discussing with management how management documents its decisions on impairment, and what type of information is available to the outside auditor to provide the requisite evidentiary support for these decisions.

Audit committees also should consider discussing with the outside auditor: (1) the auditor's assessment of audit risk in this area; (2) what the auditor's strategy will be for dealing with this risk; and (3) the results of audit procedures performed in relation to this risk.[69] The PCAOB made the same recommendation with respect to other areas of deficiency listed in the report, such as fair value measurements, allowance for loan losses, impairment of intangible assets other than goodwill (as well as tangible assets), off-balance sheet structures, revenue recognition, inventory valuation, and income taxes.

Segments

Many companies have responded to volatile business and market conditions by restructuring their operations, leading in some cases to significant changes in how they manage their businesses. Alert to the possibility that some companies may not have reassessed their definition of U.S. GAAP segments in light of these developments in accordance with ASC Topic 280, the Division of Corporation Finance is checking during the review process for the consistency between a company's disclosures in the MD&A and the financial statement footnotes, on the one hand, and, on the other, those disclosures made in connection with webcast earnings calls and investor conferences. The staff also may consider how the market views the company, examining analyst reports and other third-party sources of public information regarding that company. If the staff spots apparent discrepancies, it may request access to the information furnished to the company's chief operating decision maker (CODM), board of directors, or audit committee. Generally speaking, the staff has been skeptical of arguments that information supplied to the CODM is not used in making judgments about the allocation of resources to the designated segments, or in evaluating their performance.

Based on analysis of supplemental materials and other information obtained during the review process, the staff has observed a common tendency to aggregate operating segments improperly, although the then-chief accountant of the Division of Corporation Finance stated that he had noticed some improvement in this area.[70] Nevertheless, the Division of Corporation Finance deputy director identified segments, including but not limited to improper aggregation, as a continuing area of staff concern during the 2011 PLI Annual Institute (an admonition later echoed by SEC accounting staff at the 2011 AICPA Conference), which means that issuers should pay careful attention to their MD&A and financial statement footnote (and business description) discussions of reportable segments. Recall also the Second Circuit's reinforcement of a similar message this year in the *Litwin* case discussed above.

Improper aggregation of operating segments in turn raises staff concerns regarding concealment of impairment risks because, as discussed above, the appropriate definition of operating segments is critical to the allocation of goodwill to reporting segments, and therefore to impairment testing. Material errors in segment accounting thus can have significant negative consequences, resulting (in a worst-case scenario) in a restatement of the company's financial statements and a determination of material weakness in its ICFR.

Foreign Currency Risk Exposure

Due to the pronounced volatility of U.S. and foreign currencies, the SEC staff indicated that the MD&A should explain the material effects of fluctuations in foreign currency exchange rates on income statement items such as revenue and cost, as well as such important operating measures as same-store sales and inventory backlog. The staff will be looking for period-over-period consistency in disclosures regarding exchange rate fluctuations, including in the context of MD&A disclosures of non-GAAP constant-currency measures (see, in this regard, Non-GAAP Financial Measures C&DI 104.06). With respect to market risk disclosures (e.g., under Item 305 of Regulation S-K, quantitative and qualitative disclosure of market risks), the staff will assess the adequacy of such disclosures against the following benchmarks: (1) the nature of currency risks pertaining to the company's countries of operation, along with any unhedged assets, liabilities and commitments; (2) risk management policies; (3) any changes in the disclosed risk exposures and how they will be managed; and (4) any known trends in currency prices or exchange rates in future operating periods, with discussion of positive trends given the same prominence as negative trends.

Non-GAAP Financial Measures

To encourage disclosure in SEC-filed documents of non-GAAP financial measures used in other corporate communications, the Division of Corporation Finance published updated interpretive guidance in 2010, and generally has taken a more flexible approach since then in connection with the review and comment process.[71]

However, the staff has continued to issue comments on perceived inconsistencies between filed and nonfiled communications with investors when non-GAAP measures appear in both, and to challenge their use in any context when deemed materially misleading. According to the staff, these comments are not intended to discourage usage of non-GAAP financial measures in filed documents (to the extent they are included), or to force non-GAAP financial measures into such documents unless the company so chooses. Instead, the staff's intent is to ensure both compliance with the plain language of the rules (Item 10(e) of Regulation S-K and Regulation G), and consistency of presentation of non-GAAP measures between formal (e.g., when such measures are included in the MD&A and/or Risk Factors sections of periodic reports) and informal (e.g., investor conferences) presentations of the company's financial condition and results of operations.

The staff indicated throughout 2011 that companies seemed increasingly to be including non-GAAP financial measures in SEC-filed documents, perhaps because of the staff's more flexible interpretive positions. Recent comments have tended to identify such noncompliant practices as giving greater prominence (in a given periodic report) to non-GAAP financial measures than to the most directly comparable GAAP measure, and mischaracterizing as nonrecurring (even implicitly) specific cash expense items that, in fact, could be regarded as recurring, rendering the non-GAAP measure materially misleading.[72] In addition, the staff has emphasized repeatedly that cash flow per share liquidity measures (as contrasted with performance measures) are potentially misleading for purposes of Regulation G and Exchange Act Rule 10b-5.

References to Credit Ratings in the MD&A and Elsewhere in Periodic Reports

Concerns arose in 2010 over the implications for company disclosure of the Dodd-Frank Act's repeal of Securities Act Rule 436(g), which previously exempted credit rating agencies from the expert consent requirements applicable to Securities Act registration statements.[73] Because the major rating agencies have indicated that they will not consent to the inclusion of ratings information in Securities Act registration statements, companies that disclose such information in periodic reports that are incorporated by reference into registration statements sought and received guidance from the Division of Corporation Finance with respect to the circumstances in which ratings disclosure is appropriate without the consent of the agency that issued the rating.

A staff interpretive position, C&DI No. 233.04, outlines the circumstances in which companies may continue to disclose credit ratings in their periodic filings (barring any other regulatory ground for exclusion, as discussed below in endnote 75; credit ratings still may appear, for example, in the MD&A liquidity and risk factor sections) without obtaining the consent of the rating agency to incorporation by reference of these filings into Securities Act registration statements.[74] Companies may provide such information, in their MD&As and risk factors, to disclose changes in credit ratings, liquidity, the cost of funds, and/or the terms of material agreements that refer to credit ratings (e.g., indenture covenants). Such references also may be included in free-writing prospectuses (which are Securities Act Section 10(b) prospectuses), but not in Rule 134 "tombstones" or other communications deemed not to be a prospectus.[75]

Internal Control over Financial Reporting

A key theme in recent staff guidance has been management's failure to consider the implications of continuing economic uncertainty for the company's internal control over financial reporting.[76] In the staff's view, reorganizations, reduced capital spending on information technology, cutbacks in staffing, and other by-products of the recent recession should be causing (individually or collectively) more disclosable changes in ICFR during a given quarterly reporting period than observed in the staff review and comment process. Other staff observations in this context:

- Disclosures of material weakness could be improved. Rather than just identifying the accounting error that is the result of a material weakness, companies also should explain what problems in the underlying control or controls ultimately led to the failure to detect or prevent the material error. Specifically, management should disclose: (1) the nature of the material weakness; (2) the impact of the material weakness on the company's financial reporting and ICFR; and (3) management's current plans or action already undertaken, if any, for remediating the material weakness.[77]
- The existence of even a single material weakness will preclude a management conclusion that the particular company's ICFR is "effective." The staff remains highly skeptical in situations where disclosure of one or more material weaknesses in ICFR, compelling a conclusion that the ICFR system is not effective, is accompanied by disclosure that the company's disclosure controls and procedures nevertheless are effective. "Because of the substantial overlap between ICFR [internal control over financial reporting] and DCP [disclosure controls and procedures], if management concludes that ICFR is ineffective, it must also consider the impact of the material weakness on its conclusions related to DCP."[78]

- Once a material weakness has been disclosed, the staff expects to see disclosure of changes in internal control *prior to completion* of remediation as the company works on correcting identified control deficiencies.
- In the event of a restatement due to material accounting error, the staff may question the absence of prior, predictive disclosure, given that a material weakness exists if a particular control deficiency (or combination thereof) creates a reasonable possibility that a material error *could* occur in the future if not corrected.[79]
- Both management and the outside auditors should "refresh" their respective approaches to evaluating ICFR each year. According to the SEC's accounting staff, "the effort must go well beyond a rollforward of testing of the operating effectiveness of the same list of controls each year. The assessment must also include the consideration of the adequacy of the design of controls. The assessment should consider, for example, whether the design of controls has kept up with economic or business conditions or changes in financial reporting requirements."[80]
- Where management uses information from third-party pricing services to formulate fair value estimates, "there is a risk that such information is inaccurate and incomplete and … that the prices they provide are not exit prices or otherwise as defined in US GAAP …."[81] Because "more complex and less actively traded securities may have a [greater] risk of misstatement. …. [m]anagement may need to design controls to appropriately weigh information received [from] multiple pricing services and/or other sources of fair value information to assure that the prices recorded for securities are indicative of fair value." In evaluating the risks of material misstatement in accordance with the SEC's 2007 interpretive guidance,[82] management should consider: (1) the "nature and complexity of securities involved (for example, the issuer, term, coupon, collateral, cash flow waterfall, priority in default and other key drivers of value);" (2) the "level of market activity for securities (for example, normal activity in market and changes thereto, nature of market (brokered, exchange, etc.), analysis of bid-ask spreads, and so forth);" and (3) the "availability [and provenance] of market data (for example, who compiles data, timeliness, alternative markets, assessment of trades for adequate size and distressed nature)."[83] Finally, depending on the nature and scope of the risks of material misstatement thus identified, management should consider strengthening the relevant ICFR by taking such measures as: (1) establishing a mechanism for "management interaction with third-party pricing services" that entails "what some call a 'pricing challenge' process[,] and through so called 'deep dives,' in which management can obtain more detailed information from pricing services about the assumptions, inputs, and other information used to price securities;" (2) implementing a process for "monitoring pricing services' assumptions and changes thereto, or "other means of monitoring market data;" and (3) obtaining independent audit reports on the internal controls of pricing services.

SEC and PCAOB Spotlight on Audit Committee Oversight of Financial Reporting

The SEC Enforcement Division has been monitoring how well audit committees have performed in discharging their oversight responsibilities in the area of financial reporting. Last year, the SEC sued three former outside directors of DHB Industries, Inc. (now known as Point Blank Solutions) for fraudulent or otherwise deficient financial disclosures in a case involving "massive accounting fraud" allegedly perpetrated by the former CEO and other employees of the company.[84] This is somewhat unusual, because the SEC generally does not sue outside directors individually unless they are believed to have been complicit in the primary violations allegedly committed by others (usually senior management or other persons responsible for the company's financial reporting) or, as here, to have failed intentionally or recklessly in their "gatekeeper" function—overseeing the integrity of the company's financial reporting process and, since Sarbanes-Oxley became law in 2002, managing the company's relationship with the outside auditor.

In announcing the SEC's filing of a case against the company and the three former directors, who had served on the company's audit committee, a senior Enforcement Division official sent this shot across the bow: "'While we won't second-guess the good-faith efforts of most company directors, we will hold accountable those who completely abdicate the duties they owe to the companies and shareholders they represent.'"[85] The case settled in November 2011, with the three defendant directors collectively agreeing (without admitting or denying culpability) to pay more than $1.6 million in monetary sanctions (including penalties and disgorgement), and accepting the imposition of officer-and-director bars and a permanent antifraud and books-and-records injunction.[86] The Enforcement Division director cited this case in written testimony to Congress describing the SEC's enforcement successes during its fiscal year ended September 30, 2011, and, in appearances at two major conferences, warned that this "message" case highlights the special responsibility of audit committees for effective oversight of corporate financial reporting.[87]

Admittedly, the allegations against the former DHB directors detail egregious misconduct by senior management (the former CEO and another ex-officer were convicted on criminal fraud and other charges arising from the same set of facts underpinning the SEC's case), along with an extraordinary degree of willful ignorance on the part of the three former directors. Although it was clearly not a run-of-the mill financial fraud case, the case should not be dismissed as largely irrelevant to most companies, because it offers a useful roadmap to the SEC's view of the financial reporting oversight duties of outside directors generally, and of audit committee members in particular. As outlined in the complaint, the three former directors were alleged to have facilitated the company's financial disclosure violations because they had been "willfully blind [for three years] to numerous red flags signaling the accounting fraud, reporting violations and misappropriation" by the then-CEO and other former managers, and allowed their personal and business relationships with the ex-CEO to impair their independent decision-making. With respect to the "red flags" the defendant directors allegedly ignored "as the fraud swirled around them," even as they were "rubber-stamp[ing] the decisions of DHB's senior management while making substantial sums from sales of DHB securities," were warnings from an in-house whistleblower and successive outside auditors (two auditing firms resigned after sending "material weakness" letters to the audit committee).

The SEC's message to audit committees (and other outside directors) is clear: The SEC expects them to maintain their independence from senior management, pay special heed to communications from outside auditors and employees alerting the audit committee to possible securities law violations, actively and independently investigate allegations of misconduct by senior management, and otherwise act diligently in discharging oversight duties owed to the company and its shareholders. State corporate law enshrines the same principle, as the Delaware Supreme Court observed in adopting the Caremark standard: "Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith."[88]

The Dodd-Frank whistleblower rules in Regulation 21F raise the stakes substantially for audit committee members and the full board, because potential whistleblowers now have strong economic incentive (accompanied by a statutory guarantee of anonymity and a new right to sue directly in federal court for retaliation) to bypass internal complaint mechanisms and share their concerns directly with the SEC. As the gatekeeper responsible under the Sarbanes-Oxley Act for establishing and administering existing whistleblower complaint procedures relating to accounting and auditing matters—and the board committee often tasked with oversight of the company's broader compliance program—the audit committee has good reason to exercise more vigilance than ever in overseeing the company's financial reporting process. Further, if a pending proposal intended to improve the quality of the outside auditor's prescribed communications with the audit committee is adopted, the PCAOB will indirectly be putting additional pressure on audit committees.[89] SEC chief accountant Jim Kroeker, in a speech touching upon the implications of the PCAOB's latest proposal regarding mandatory auditor communications with audit committees, encouraged audit committees "to take a fresh look at how they can improve their current auditor oversight responsibilities so that they can be an even greater influence on improving audit quality."[90]

Audit committees should be aware that the SEC and the PCAOB have consolidated their efforts to improve the quality of corporate financial reporting by taking measures to strengthen the critical relationship between the two major Sarbanes-Oxley "gatekeepers"—the independent nonemployee directors of listed companies who comprise the audit committee, and the independent auditor responsible for the integrated audit of the financial statements and the ICFR. As the PCAOB put it, an important goal of the now-reproposed auditing standard is to promote "effective two-way communications between the auditor and the audit committee throughout the audit[,]" which will have the two-fold benefit for investors of helping the auditor to "conduct an effective audit … [,]" and the audit committee to "fulfill its oversight responsibilities regarding the financial reporting process." The standard, if adopted and approved by the SEC, would become effective for audits of fiscal years beginning on or after December 15, 2012—meaning 2013 for calendar-year reporting companies. Audit committee members should consider whether it makes sense to act now to enhance committee procedures and their dialogue with the outside auditor in light of the goals of the reproposed standard.

What could all this mean for audit committees?

- First, outside auditors will expect their communications with audit committees to be "meaningful," within the plain language and the spirit of the new PCAOB auditing standard (as reproposed). An inevitable consequence of the adoption of this enhanced standard is that the PCAOB inspections staff will be selecting specific company audit engagements to assess how well PCAOB-registered auditors are doing in complying with that standard. As noted above, auditors are being pressed by the PCAOB on a number of fronts to demonstrate more professional skepticism regarding management estimates and assumptions, particularly given the troubled economic environment and enhanced fraud risks associated with aggressive accounting decisions by management pressured to hit corporate performance targets in declining markets. Because more is expected of auditors, they, in turn, will expect more of their fellow gatekeeper, the audit committee. If the PCAOB staff finds what it considers to be a failed or otherwise deficient audit, it may pick up the phone and communicate this information to its counterparts at the SEC.
- Second, the audit committee should be prepared for several detailed requirements in the new standard designed to "enhance and improve" the "two-way communications" between auditor and audit committee. For example, the new standard would compel the auditor to expand its inquiries of the audit committee regarding "matters relevant to the audit." These matters would include the audit committee's knowledge of actual or possible violations of law or regulations, whether or not pertaining directly to financial reporting issues. Accordingly, now is a good time for companies, under the oversight of the audit committee, to reevaluate existing internal whistleblower complaint policies and procedures, both (1) to determine whether they are sufficient to supply the audit committee with the information that soon will be necessary to answer the auditor's questions; and (2) to assist the company in responding effectively to the Dodd-Frank whistleblower rules by, if necessary, ensuring that current complaint mechanisms cover all actual or potential violations of applicable law and regulation, not just those complaints or concerns involving accounting and auditing matters as contemplated by Sarbanes-Oxley.
- Another requirement under the reproposed PCAOB standard would impose an obligation on the auditor to communicate to the audit committee "complaints or concerns regarding accounting or auditing matters that have come to the auditor's attention during the audit." This requirement could have the effect of reinforcing auditor compliance with the Exchange Act Section 10A "accountant whistleblower" provisions, which direct the auditor to "assure" that the audit committee or full board is "adequately informed" of any "illegal acts" (unless "clearly inconsequential") that the auditor detects or otherwise learns of in the course of an audit, in addition to informing senior management. (Recall, however, that only if senior management and/or the audit committee or full board fails to take "timely and appropriate remedial actions with respect to the illegal act," must the auditor submit a report of its conclusions to the full board and the SEC.)

While most audit committees are well-prepared to meet these challenges, audit committee members must remain vigilant and continue to seek and obtain the current information and assistance they need to exercise their fiduciary oversight duties in an effective manner. We hope this report facilitates the continuing oversight process for outside directors and the work of the senior managers and others responsible for the financial reporting operations of public companies.

ENDNOTES

1 SEC Rel. No. 33-9106, "Commission Guidance Regarding Disclosure Related to Climate Change," February 2, 2010 (www.sec.gov/rules/interp/2010/33-9106.pdf).

2 *Ibid* at p. 17.

3 *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1318 (2011).

4 *Matrixx*, *supra* n. 4, at 1313-14. Earlier, in *Basic Inc. v. Levinson, Inc.*, 485 U.S. 224 (1985), the Supreme Court similarly rejected a "bright-line" test that had been applied by some lower courts in analyzing the materiality of preliminary merger negotiations. When assessing the materiality of contingent or speculative information or events, such as whether a proposed merger will be consummated, a materiality judgment necessarily "'will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.'" 485 U.S. at 238 (citation omitted). See also Climate Change Release p. 18.

5 485 U.S. at 231-32 (quoting from *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976) at 449).

6 Ibid. at 236.

7 SEC Rel. No. 33-6835, "Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures," May 18, 1989, (www.sec.gov/rules/interp/33-6835.htm).

8 Climate Change Release, p. 18.

9 634 F. 3d 706 (2d Cir. 2011), *cert. den.*, 2011 U.S. LEXIS 5436 (U.S., Oct. 3, 2011).

10 *Litwin* p. 716 (noting that the plaintiffs' burden of pleading was "relatively minimal" because of the absence of a scienter element in causes of action brought under Sections 11 and 12(a)(2) of the Securities Act of 1933, as amended).

11 Ibid. pp. 716-717. According to the court, the "materiality" test—as applied here to construing allegations of failure to comply with Item 303(a)'s "known trends and uncertainties" element in violation of Sections 11 and 12(a)(2) of the Securities Act—is the same in the antifraud context.

12 The SEC has repeatedly emphasized the evolutionary nature of "circumstances and risks" facing public companies, and the concomitant need to reassess the implications of such circumstances and risks over time with a view toward disclosure. In this regard, informational items that may not be deemed material when considered in the context of annual results, nevertheless may be material in the context of interim results disclosed in a Form 10-Q. See SEC Rel. No. 33-9144, "Commission Guidance on Presentation of Presentation of Liquidity and Capital Resources Disclosures in Management's Discussion and Analysis Liquidity and Capital Resources Disclosures in Management's Discussion and Analysis," September 17, 2010 (MD&A Liquidity Release) (citation omitted) (www.sec.gov/rules/interp/2010/33-9144.pdf).

13 Where PSLRA safe harbor coverage is unavailable, companies still may rely on the judicially-crafted "Bespeaks Caution" doctrine in defending against securities fraud claims, to support an argument that a challenged misstatement or omission is immaterial as a matter of law. Much like the PSLRA safe harbors, however, the doctrine requires that cautionary language specifically warn of, and relate directly to, the risk that allegedly triggered a plaintiff's loss. See *Halperin v. eBankerUSA.com*, 295 F. 3d 352, 359 (2d Cir. 2002).

14 Note that disclosures made in the financial statements do not qualify for PSLRA safe harbor coverage.

15 The deputy chief counsel of the SEC's Division of Corporation Finance highlighted the importance of the *Slayton* case during the Practising Law Institute's "SEC Speaks" conference held February 4-5, 2011. The Division's deputy director later reinforced the message of this case at the 2011 PLI Annual Institute.

16 604 F. 3d 758 (2d Cir. 2010), *pet. for panel or en banc rehearing denied*, 2010 U.S. App. LEXIS 18384 (2d Cir., July 23, 2010). The effectiveness of well-crafted risk factors was recently demonstrated in another Second Circuit decision, upholding the lower court's dismissal of a private Securities Act complaint challenging statements of management "opinion"—estimates, judgments and assumptions relating to goodwill impairment and loan loss reserves—that were set forth in financial statements comprising part of a Form 10-K incorporated by reference into a Securities Act registration statement. *See Fait v. Regions Financial Corporation*, 655 F. 3d 105, 111 n. 3 (2d Cir. 2011) (focusing on disputed goodwill judgments made by management in support of disclosures made in financial statements filed as part of the Form 10-K).

17 The court found that the disputed forward-looking statement was not made with actual knowledge of falsity and, therefore, was protected by a separate prong of the PSLRA safe harbor than the one discussed above in the text. See *Slayton*, 604 F. 3d pp. 774-78.

18 Ibid. at 773. The court stated that, "the consistency of the defendants' [risk factor] language over time despite the new information they received in early May 2001 [indicating that the value of a subsidiary's high-yield bond portfolio actually would continue to deteriorate in the remainder of 2001] belies any contention that the cautionary language was 'tailored to the specific future projection'...."

19 Ibid.

20 MD&A Liquidity Release. Foreign private issuers should be aware that, while directed primarily to domestic companies, the MD&A Liquidity Release is also relevant to disclosure provided in the Operating and Financial Review and Prospects section required by Item 5 of Form 20-F.

21 SEC Rel. No. 33-9143, "Short-Term Borrowing Disclosure," September 17, 2010, (www.sec.gov/rules/proposed/2010/33-9143.pdf).

22 Division of Corporation Finance Director Meredith B. Cross reportedly indicated, during a Practising Law Institute program held June 22, 2011, entitled "Audit Committee Workshop 2011," that: "Commenters said the SEC went too far in the proposed quantification requirements, especially for nonfinancial service companies .... The staff is working on a draft that will scale back some of the requirements for these companies...." SEC Today Online, CCH, Vol. 2011-124, June 28, 2011 (Cross Remarks) (http://prod.resource.cch.com/resource/scion/toc/atlas-toc/(WKUS_TAL_2855)79FDFE3F81E9E1E1C019FEB4:WKUS_TAL_2855%2309013e2c8752ed18/?cfu=Legal subscription required).

23 MD&A Liquidity Release, p. 4.

24 Sample Letter Sent to Public Companies Asking for Information Related to Repurchase Agreements, Securities Lending Transactions, or Other Transactions Involving the Transfer of Financial Assets, March 2010, (www.sec.gov/divisions/corpfin/guidance/cforepurchase0310.htm).

25 MD&A Liquidity Release p. 6 (citing Item 303(a)(1) of Regulation S-K).

26 Ibid. See also SEC Rel. No. 33-8350, "Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations," December 19, 2003 (2003 MD&A Interpretive Release); SEC Rel. No. 33-8182, "Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations," January 28, 2003, (www.sec.gov/rules/final/33-8182.htm).

27 MD&A Liquidity Release, pp. 8-9. See also Section VI.F., *infra* (discussing non-GAAP financial measure disclosure requirements). If the disclosed ratio is a nonfinancial measure, management should look to the disclosure guidance outlined in the 2003 MD&A Interpretive Release. See MD&A Liquidity Release at note 13 and accompanying text.

28 Ibid. p. 9.

29 Ibid.

30 Ibid. p. 7.

31 Ibid.

32 Ibid. p. 10. In light of the SEC's publication of interpretive guidance, the Division of Corporation Finance accounting staff amended the FRM in early 2011 to delete prior staff guidance on disclosure in the contractual obligations table. The FRMis available on the SEC's website (www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf).

33 MD&A Liquidity Release, p. 11 n. 17.

34 CF Disclosure Guidance: Topic No. 4, January 6, 2012, (www.sec.gov/divisions/corpfin/guidance/cfguidance-topic4.htm).

35 "Current Developments in the Division of Corporation Finance," National Conference on Current SEC and PCAOB Developments, Washington, D.C., December 6, 2011, (2011 AICPA Slide Deck) ("Considerations not just for banks and financial institutions.") (www.sec.gov/news/speech/2011/spch120611nsco.pdf).

36 CF Disclosure Guidance: Topic No. 2, October 13, 2011, (www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm).

ENDNOTES (continued)

37 Letter to SEC Chairman Mary Schapiro from Senators Jay Rockefeller, Robert Menendez, Sheldon Whitehouse, Richard Blumenthal and Mark Warner, dated May 11, 2011 (http://commerce.senate.gov/public/?a=Files.Serve&File_id=4ceb6c11-b613-4e21-92c7-a8e1dd5a707e).

38 See Summary of Board Decisions, November 10, 2010 FASB Board Meeting, (www.fasb.org), indicating that the FASB Board did not reach any decision at this meeting on whether to proceed with the July 2010 Exposure Draft, Contingencies (Topic 450): *Disclosure of Certain Loss Contingencies*, or the major issues to be redeliberated in light of public comment on the foregoing exposure draft, but directed its staff "to work with the staffs of the SEC and PCAOB to understand their efforts in addressing investor concerns about the disclosure of certain loss contingency [sic] through increased focus on compliance with existing rules. The Board also directed the staff to review filings for the 2010 calendar year-end reporting cycle to determine if those efforts have resulted in improved disclosures about loss contingencies."

39 For example, SEC Chairman Mary Schapiro pointed out that, "our disclosure teams [in the Division of Corporation Finance] are asking institutions to clarify their exposure to potential losses due to litigation and other contingencies. … These are not new requirements–they are currently what the accounting standard requires." SEC Chairman Mary L. Schapiro, "Remarks Before the Women in Finance Symposium," July 12, 2011) (Schapiro Remarks), (www.sec.gov/news/speech/2011/spch071211mls.htm).

40 See, e.g., 2011 AICPA Slide Deck; Tammy Whitehouse, "SEC Calls for Companies to Disclose Europe Debt Exposure," *Compliance Week*, December 13, 2011, ; Tammy Whitehouse, "SEC Still Seeks Better Contingency Disclosures," *Compliance Week*, August 2011 (reporting statements made by senior Division of Corporation Finance accounting officials during a June 24, 2011 webcast hosted by the AICPA's Center for Audit Quality).

41 PCAOB Staff Audit Practice Alert No. 7, "Auditor Considerations of Litigation and Other Contingencies Arising From Mortgage and Other Loan Activities," December 20, 2010, (www.pcaobus.org). This staff alert is intended to supplement guidance given to preparers of financial statements in an October 2010 "Dear CFO" Letter issued by the SEC staff, discussed in the text accompanying footnote 48, below.

42 Auditors are reminded in PCAOB Audit Practice Alert No. 7 to consult PCAOB Staff Audit Practice Alert No. 3, "Audit Considerations in the Current Economic Environment," December 5, 2008, (www.pcaobus.org/Standards/QandA/12-05-2008_APA_3.pdf). The warnings conveyed in Alert No. 3 were repeated in PCAOB Staff Audit Practice Alert No. 9, "Assessing and Responding to Risk in the Current Economic Environment," December 6, 2011, (http://pcaobus.org/Standards/QandA/12-06-2011_SAPA_9.pdf).

43 Corporate audit committees should consider, whether in the context of engaging the outside auditor or otherwise, discussing the circumstances under which the PCAOB-registered independent public accounting firm serving as outside auditor will disclose to the audit committee that: (a) the PCAOB staff has selected the particular company's audited financial statements for review (as part of the inspection process, in assessing the level of the outside auditor's compliance with PCAOB-prescribed auditing standards); and/or (b) in finding certain audit deficiencies, the PCAOB staff has called into question management's application of GAAP in preparing the audited financial statements. Clarification of these circumstances is very important, because the PCAOB staff may, in its discretion, refer the matter to the SEC's accounting staff, inasmuch as the PCAOB has no jurisdiction over the company itself. At least some such referrals reportedly have led to restatements.

44 Current Accounting and Disclosure Issues Outline, November 30, 2006 (not part of the FRM, but has not been superseded) (www.sec.gov/divisions/corpfin/cfacctdisclosureissues.pdf).

45 Wayne Carnall, Chief Accountant, Division of Corporation Finance, Slide Presentation (PDF): Remarks before the 2010 AICPA Conference on Current SEC and PCAOB Developments, December 7, 2010 (www.sec.gov/news/speech/2010/spch120710wc.pdf).

46 See, e.g., 2011 AICPA slide deck; Whitehouse (reporting remarks made by two Deputy Chief Accountants of the Division of Corporation, Craig Olinger and Nili Shah); Cross remarks; and oral remarks of Wayne Carnall, at PLI's "The SEC Speaks in 2011" February 4, 2011, (Carnall Remarks). A webcast version of this program is available (for a fee) at http://www.pli.edu.

47 Division of Corporation Finance, "Sample Letter Sent to Public Companies on Accounting and Disclosure Issues Related to Potential Risks and Costs Associated with Mortgage and Foreclosure-Related Activities or Exposures," October 2010, (www.sec.gov/divisions/corpfin/guidance/cfoforeclosure1010.htm). While focused on an area that has been problematic primarily for companies such as banks, mortgage lenders and reinsurers, the guidance on disclosure of loss contingencies outlined in this letter has broader applicability.

48 In this regard, SEC Chairman Schapiro observed: "In the past, companies have often claimed that they were unable to accurately calculate their exposure, or they failed altogether to provide this information–arguing that doing so would prejudice their positions [in litigation]. We are asking that they begin providing this information if they have not been already, and that they ensure they refine their calculations over time as events and circumstances change and new information is obtained." See Schapiro Remarks.

49 See, e.g., Cross Remarks; Whitehouse, "SEC Still Seeks Better Contingency Disclosures," (reporting remarks of Division of Corporation Finance Deputy Chief Accountant Nili Shah).

50 Cross Remarks.

51 2011 AICPA Slide Deck.

52 *See* PCAOB Staff Audit Practice Alert No. 9.

53 Ibid. p. 7.

54 2011 AICPA Slide Deck.

55 Jason K. Plourde, Professional Accounting Fellow, Office of the Chief Accountant, U.S. Securities and Exchange Commission, remarks before the 2011 AICPA National Conference on Current SEC and PCAOB Developments, December 5, 2011 (Plourde Remarks), (www.sec.gov/news/speech/2011/spch120511jkp.htm).

56 PCAOB Rel. No. 2010-066, "Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis," September 29, 2010, (PCAOB Audit Risk Report), p. 20 (www.pcaobus.org/Inspections/Documents/4010_Report_Economic_Crisis.pdf).

57 FRM at Section 9220.4.

58 Ibid.

59 2011 AICPA Slide Deck; Tammy Whitehouse, "SEC Squinting at Overseas Earnings," *Compliance Week,* August 2011, pp. 28-29 () (Whitehouse, Tax) reporting on remarks of Division of Corporation Finance Associate Chief Accountant Mark Shannon, made during a Compliance Week 2011 conference).

60 2011 AICPA Slide Deck.

61 Whitehouse, Taxt p. 63.

62 PCAOB Audit Risk Report, p. 20.

63 2011 AICPA Slide Deck.

64 For an informative discussion of goodwill impairment testing under former FAS 141, now FASB ASC Topic 350, see the Second Circuit's decision in *Fait v. Regions Financial Corp*, *supra* n. 17. In this case, the Court of Appeals upheld the lower court's determination (ruling on a defense dismissal motion) that management decisions regarding the need for goodwill impairment testing–along with other disputed management judgments, estimates and assumptions involved in calculating goodwill and loan-loss reserves underpinning disclosure in a Form 10-K incorporated by reference into a Securities Act registration statement–were nonactionable statements of opinion rather than actionable misstatements of material fact. In reaching this conclusion, the Court of Appeals applied, in a Securities Act context, the Supreme Court's reasoning in *Virginia Bankshares v. Sandberg*, 501 U.S. 1083 (1991), which involved Exchange Act Rule 14a-9 (proxy antifraud). *See also* n. 17, *supra* (discussing the Court of Appeals' consideration, applying the same materiality analysis, of a risk factor relating to loan loss reserves).

65 The optional qualitative impairment assessment is effective for annual and interim impairment tests in fiscal years beginning on or after December 15, 2011, but early adoption is permitted.

66 FRM at Sections 9510.2 and .3.

67 PCAOB Audit Risk Report.

68 Ibid. pp. 13-14.

69 Ibid. pp. 2-3.

70 Carnall Remarks.

71 Non-GAAP Financial Measures, Compliance and Disclosure Interpretations, January 15, 2010, (www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm); FRM at Topic 8. A new C&DI was issued on July 8, 2011, relating to disclosure of non-GAAP financial measures in the Compensation Discussion and Analysis or other parts of the annual meeting proxy statement in which executive and director compensation information is provided (www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm).

ENDNOTES (continued)

72 See, e.g., Shayndi Raice and Nick Wingfield, "Groupon's Accounting Lingo Gets Scrutiny," *The Wall Street Journal*, July 28, 2011 (reporting SEC staff's apparent objection to use in an IPO registration statement of a non-GAAP financial measure that excludes such ostensibly recurring items as marketing costs). The staff's comments and Groupon's responses are available on the SEC's website (www.sec.gov) via EDGAR.

73 Section 936G of the Dodd-Frank Act repealed Securities Act Rule 436(g), effective July 22, 2010. The SEC staff published relief for two classes of registrants affected somewhat differently by this repeal (given the refusal of the credit rating agencies to issue expert consents to either class of registrant), as follows: (a) for non asset-backed companies, in the form of the C&DI discussed below in the text; and (b) for asset-backed issuers, a global no-action letter issued on July 22, 2010, to Ford Motor Credit Company LLC and Ford Credit Auto Receivables Two LLC, which was replaced by a subsequent letter issued to these entities on November 23, 2010 (www.sec.gov/divisions/corpfin/cf-noaction/2010/ford072210-1120.htm).

74 Securities Act Rules, Compliance and Disclosure Interpretations, updated March 4, 2011, (www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm). See also Securities Act C&DI Nos. 198.08, 233.04-.08.

75 As part of a much broader regulatory response to another Dodd-Frank Act mandate, set forth in Section 939A of the Act–to remove references to credit ratings in rules and forms under the Securities Act and the Exchange Act–the SEC recently amended Securities Act Rule 134 to eliminate the safe harbor for inclusion of credit ratings in so-called "tombstones" and other communications defined under Rule 134 not to constitute either a "prospectus" within the meaning of Securities Act Section 2(a)(10), or a "free-writing prospectus" for purposes of Rule 405 under the Securities Act. See SEC Rel. No. 33-9245, "Security Ratings," July 27, 2011 (www.sec.gov/rules/final/2011/33-9245.pdf). According to the SEC, issuers may continue to argue that credit rating disclosures in connection with registered offerings that no longer qualify for the Rule 134 safe harbor nevertheless are not "prospectuses" when analyzed in light of all relevant facts and circumstances surrounding the particular communication.

76 See, e.g., Carnall Remarks.

77 FRM at Section 4310.12.

78 See ibid. at Section 4310.9.

79 See ibid. at Section 4310.16.

80 Brian T. Croteau, Deputy Chief Accountant, Office of the Chief Accountant, U.S. Securities Exchange Commission, remarks before the 2010 AICPA National Conference on Current SEC and PCAOB Developments December 6, 2010, (www.sec.gov/news/speech/2010/spch120610btc.htm).

81 Plourde Remarks.

82 SEC Rel. No. 33-8810, "Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934," June 20, 2007, (www.sec.gov/rules/interp/2007/33-8810.pdf).

83 Plourde Remarks.

84 SEC Press Rel. No. 2011-52, "SEC Charges Military Body Armor Supplier and Former Outside Directors With Accounting Fraud," Febraury 28, 2011, (www.sec.gov/news/press/2011/2011-52.htm).

85 Ibid.

86 SEC Press Rel. No. 2011-238, "Three Former Directors at Military Body Armor Supplier Settle SEC Charges," November 10, 2011, (www.sec.gov/news/press/2011/2011-238.htm).

87 Remarks made by Mr. Khuzami during the 2011 AICPA Conference and the 2011 PLI Annual Institute, and in respect of the latter conference, are available on the PLI website at (http://www.pli.edu) for webcast replay (for a fee).

88 *Stone v. Ritter*, 911 A. 2d 362, 370 (Del. 2006).

89 PCAOB Rel. No. 2011-008, "Proposed Auditing Standard Related to Communications with Audit Committees," December 20, 2011, (www.pcaobus.org).

90 Remarks of James L. Kroeker, Chief Accountant, U.S. Securities and Exchange Commission, before the 2011 AICPA National Conference on SEC and PCAOB Developments December 5, 2011, (www.sec.gov/news/speech/2011/spch120511jlk.htm).

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