

January 30, 2007

SEC Accounting Staff Offers Guidance on Restatements for Errors Resulting from Options Backdating

On January 16, 2007, the Chief Accountant of the SEC's Division of Corporation Finance posted on the SEC website a "Sample Letter Sent in Response to Inquiries Related to Filing Restated Financial Statements for Errors in Accounting for Stock Option Grants" (the "January 16th Letter"). The January 16th Letter, which can be found at <http://www.sec.gov/divisions/corpfin/guidance/oilgasltr012007.htm>, summarizes recent conversations the Staff has had with companies preparing to restate their financial statements due to errors in accounting resulting from options backdating.

In the January 16th Letter, the Staff acknowledges that restatements for accounting errors for backdated option grants could involve a number of years of restatements and that correcting all previously filed reports would be unduly burdensome to the reporting company and confusing to investors. The Staff therefore has indicated that the restatements may be contained in a single amendment to the company's most recent Annual Report on Form 10-K (or where the current Form 10-K is due within two weeks, the company may instead include the disclosure in that Form 10-K, rather than in an amendment), provided that the filing contains the following:

- An explanatory note that states the reason for the filing.
- Restated Selected Financial Data with columns entitled "Restated".
- MD&A for each relevant restated interim and annual period. The MD&A should discuss operating results, trends, and liquidity. Discussions on interim periods may be provided in the annual period discussions or may be presented separately.
- Audited annual financial statements for the most recent three years, restated as necessary, with columns entitled "Restated".
- If interim period information for the most recent two fiscal years as required by Item 302 of Regulation S-K is required to be restated, the information presented for balance sheets and statements of income should be provided with a level of detail set forth in Regulation S-X Article 10-01(a)(2) and (3) and relevant sections of 10-01(b). Columns should be entitled "Restated." The Staff noted that companies need not present cash flows, as such information is not required under Item 302 of Regulation S-K.

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- Footnote disclosure reconciling previously filed annual and quarterly financial information to the restated financials, on a line-by-line basis and with separate disclosure for each material type of error, within and for the periods presented in the audited financial statements, in selected financial data and in the interim period information.
- The disclosure referred to in a letter by Conrad Hewitt, Chief Accountant of the SEC, dated September 19, 2006, which discusses certain of the existing accounting guidance related to grants of stock options (at http://www.sec.gov/info/accountants/staffletters/fei_aicpa091906.htm).
- Audited financial statement footnotes of the nature and amount of each material type of error included in the cumulative adjustment to opening retained earnings.
- Audited financial statement footnote disclosure of the restated stock compensation cost containing the following:
 - **For the most recent three years:** restated net income and compensation cost and pro forma disclosures, as required by paragraph 45.c of FASB Statement No. 123 Accounting for Stock-Based Compensation, and clarified and amended by FASB Statement No. 148, for each annual period presented in the financial statements for which the intrinsic value method of accounting in APB Opinion 25 was used. Columns should be entitled “Restated”.
 - **For each annual period preceding the most recent three years:** restated stock compensation cost that should have been reported for each fiscal year, as required by paragraph 45.c.2. of FASB Statement No. 123. The total of the restated stock-based compensation cost should be reconciled to the disclosure of the cumulative adjustment to opening retained earnings. While the disclosure required by paragraph 45.c.2. is net of tax, material tax adjustments related to the accounting for stock-based compensation should also be disclosed by year. Companies may also choose to voluntarily provide the full restated information previously disclosed pursuant to paragraph 45.c. of FASB Statement No. 123 for each period prior to the most recent three years, either in the audited financial statement footnotes or elsewhere in the filing.
 - **For companies that adopted (1) FASB Statement No. 123 using the retroactive restatement method specified in FASB Statement No. 148 and/or (2) FASB Statement No. 123R, *Accounting for Share-Based Payment*, using the modified retrospective application method for all prior years for which FASB Statement No. 123 was effective:** the disclosure outlined in the preceding two paragraphs should include the restated stock-based compensation pursuant to FASB Statement No. 123 and also the restated stock-based compensation cost that should have been reported under the accounting principle originally used for each period, presumably Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*.

- Any necessary revisions to previous disclosure under Items 9A and 9B of Form 10-K, particularly in light of the restatement, including whether any material weaknesses were identified and the nature and impact of such weaknesses. The Staff noted in the January 16th Letter that while there is no requirement for management to reassess its original conclusion on the effectiveness of its internal control over financial reporting, it should nevertheless consider whether the original disclosure is appropriate, providing any other material information necessary to ensure that the original disclosure is not misleading.

The Staff further noted that a company's compliance with the January 16th Letter would not preclude the Staff from taking further action in light of the restatement, including:

- Commenting on or requesting changes to a Form 10-K amendment or Form 10-K;
- Determining that the company has not complied with all applicable financial statement requirements;
- Determining that the company has not satisfied all rule and form eligibility standards under the Securities Act and the Exchange Act;
- Concluding that the company is not current in its Exchange Act filings;
- Concluding that the company has not complied with the reporting requirements of the Exchange Act;
- Taking action recommended by the Division of Enforcement with respect to the company's restatements; and
- Taking action recommended by the Division of Enforcement under Section 304 of the Sarbanes-Oxley Act, *Forfeiture of Certain Bonuses and Profits*.

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This summary of the January 16th Letter is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Moreover, we are not accountants and do not purport to be interpreting any accounting statements. Questions concerning disclosure issues addressed in this memorandum should be directed to any member of the Paul Weiss Securities Group, including:

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