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BDO Seidman, LLP
Accountants and Consultants



Financial Reporting

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Report on AICPA SEC and PCAOB Conference

The annual AICPA National Conference on Current SEC and PCAOB Developments held on December 5-7, 2005 in Washington, D.C., provided insights into the Securities and Exchange Commission (SEC) staff's views on various accounting and reporting issues. The remarks made by Chairman Christopher Cox, Commissioner Paul Atkins, the Acting Chief Accountant, the Chief Accountant of the Division of Corporation Finance, and members of the staff of the Office of the Chief Accountant may be accessed at the SEC's Web site, www.sec.gov, under *Speeches and Public Statements*. The remarks made by other members of the Division of Corporation Finance at the conference are not publicly available.

Summary

The signing of the Sarbanes-Oxley Act of 2002 was the impetus for significant changes that impacted public companies, management, audit committees, independent auditors, and others. In just over three years these changes included: CEO/CFO certifications, more audit committee involvement/accountability, regular periodic SEC review of filings, PCAOB auditor oversight, and reporting on effectiveness of internal control over financial reporting.

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Although encouraged by the changes and the progress that has been made, the SEC stressed that more changes are needed to ensure that the financial reporting system is operating effectively and efficiently. The focus for the future should be on reducing the complexity of existing GAAP and encouraging preparers and auditors to consistently exercise professional judgment when applying the standards.

The comments that follow elaborate on these items and provide additional insight into the SEC positions.

Complexity in financial reporting

The SEC staff believes that a number of factors have contributed to the complexity that currently exists in many areas of GAAP. Specifically:

- Constituent demands for detailed bright lines, exceptions to principles, or optional treatments (e.g., short-cut method to simplify hedge accounting for certain interest rate hedges or the creation of qualifying special purpose entities to facilitate sale accounting in certain securitization transactions)
- A desire to reduce income statement volatility (e.g., smoothing mechanisms allowed under defined-benefit pension plan accounting)
- Concerns about being second guessed (i.e., in the absence of written guidance from the Financial Accounting Standards Board (FASB) or SEC, insisting on the most conservative interpretations – the “safe” answers)

Accommodations made by standard-setters in response to these requests have made GAAP more complex, increasing the possibility

of errors in the underlying calculations or assumptions.

The SEC staff acknowledged that it has played a part in this increasing complexity. As a matter of policy, the staff indicated that it does not rely on bright-lines (often not found in literature), reject differing interpretations based on reasonable judgments, or reject the notion that reasonable diversity may exist in practice. Nevertheless, the perception that it does these things has resulted in additional requests for specific guidance and exceptions for certain transactions/treatments.

The staff encouraged registrants to take advantage of opportunities to voluntarily improve financial reporting now and not wait for future changes in standards. Such opportunities could include the following:

- Preparing cash flow statements under the direct method
- Choosing not to aggregate operating segments
- Presenting the income statement by natural classification (e.g., salaries, rent expense, etc.) as well as by function
- Adopting more rigorous other-than-temporary impairment policies
- Choosing not to apply hedge accounting

Fair value accounting is often cited as a significant contributor to complexity. Although fair value may at times be more difficult to apply, the staff indicated that greater overall use of fair value accounting might actually reduce complexity. Using Statement of Financial Accounting Standard (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as an example, if all financial instruments were recorded at fair value, embedded derivatives would not have to be identified and hedge accounting (including its rules and

documentation requirements) would not have to be applied to hedges of financial instruments.

Professional Judgment

Over the years the SEC staff has seen significant swings in the application of professional judgment. The pendulum has swung from the late 1990s when judgment was often applied to justify an overly aggressive interpretation of the accounting literature to the present where usually only the “safest” answer is considered appropriate.

Although the current position may well be a result of the increased scrutiny of financial reporting (and of auditors in particular), it diminishes the importance of professional judgment and makes the intended move to principles-based standards even more difficult. Professional judgment – based on intelligence, training, and analytical skills – should be used to apply the accounting literature in the way that will best communicate with investors; not to arrive at the most aggressive or most conservative interpretation.

Redeemable Equity Securities

Redeemable securities, whose redemption is outside a company's control, but not mandatory, are recorded at issue date at fair value and classified outside of stockholders' equity (i.e., as mezzanine or temporary equity). Under EITF Topic D-98, *Classification and Measurement of Redeemable Securities*, subsequent measurement depends on whether or not the securities are currently redeemable and if not, on whether future redemption is probable. Specifically, subsequent accretion to redemption value is only required

for securities that are currently redeemable (at each balance sheet date) or for securities whose future redemption is probable (accreted over the period from issue date to first possible redemption date). No subsequent accretion is needed if redemption is not probable (e.g., contingent on a future event).

Some redeemable securities provide the holder with mutually exclusive options. For example, a security may allow the holder to (a) immediately convert into a fixed number of common shares (conversion option) or (b) redeem for cash after a specified period of time (redemption option). Since the holder may convert to common shares – thus eliminating future redemption – some companies have argued that redemption is not probable and subsequent fair value adjustments are not required. The SEC staff believes that the likelihood of other options being exercised by the holder (i.e., conversion option) should not be considered when assessing probability. In these situations, the redemption of such instruments should be considered probable regardless of the likelihood of an earlier conversion.

Valuation of financial instruments

The SEC staff believes that available quoted market prices provide the best evidence of fair value and that discounts to market (referred to as “block discounts”) should not be applied. As support for this position, the staff cited paragraphs 5, 6, and 58 of SFAS No. 107, *Disclosures about Fair Value of Financial Instruments*, paragraph 3a of SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and footnote 3 of EITF Issue No. 98-5, *Accounting for Convertible Securities with Beneficial Conversion*

Features or Contingently Adjustable Conversion Ratios. Such literature not only demonstrates that the FASB has considered the issue of block discounts on multiple occasions but that it has been consistent in its conclusions. The staff also noted that this position is consistent with the FASB working draft on *Fair Value Measurements*, which is expected to be issued in early 2006.

Warrants issued to non-employees often contain unique features that need to be considered when determining fair value. Unlike options granted to employees, warrants granted to non-employees are usually transferable without restriction and subject to immediate exercise. As a result, the SEC staff believes that the contractual term – not the expected term – should be used for valuation purposes when using the Black-Scholes model.

Customer-Related Intangible Assets

In some business combinations, the acquirer may already have pre-existing relationships with the target’s customers. For example, prior to a business combination, both the acquirer and the target may sell different – or even competing – products to the same customers. Since there are no new customers in these situations, some have argued that no value should be attributed to the customer relationships. The staff disagrees and believes that these relationships do have value because the business combination will most likely result in the acquirer being able to sell new products to its existing customers or, where competing products are involved, to increase its shelf space.

When valuing customer related intangible assets involving a pre-

existing relationship, the staff believes that an income approach, reflecting the estimated future benefits of the cash flows expected to be generated from the incremental sales, is most appropriate. The staff has generally challenged valuations based on a cost approach, believing that such models have historically failed to capture all costs necessary to rebuild the customer relationships.

Marketplace participant assumptions – not entity specific assumptions – should be used in the fair value model. While the proposed amendments to SFAS No. 141, *Business Combinations*, and the proposed standard on Fair Value Measurement will most likely clarify this issue, the staff believes this position is currently supported by both SFAS No. 141 and EITF Issue No. 02-17, *Recognition of Customer Relationship Intangible Assets Acquired in a Business Combination*.

Pre-existing Relationships in a Business Combination

Settlement of pre-existing relationship

EITF Issue No. 04-1, *Accounting for Preexisting Relationships between the Parties to a Business Combination*, addresses transactions involving both a business combination and the settlement of an existing relationship. In simple terms, to the extent the contractual terms are favorable or unfavorable to the market prices there is a settlement gain or loss. Such accounting eliminates the ability to capitalize the buyout of unfavorable arrangements (e.g., supply contracts or lawsuits) as goodwill.

The actual accounting is not always clear when a company acquires less than 100% of another

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company with whom it has a relationship. Determining the settlement gain or loss in a “partial” acquisition requires consideration of all of the facts and circumstances and an analysis of the impact on the value lost or gained by the other shareholders.

For example, a 40% shareholder and party to an unfavorable supply contract with the investee may purchase an additional 15% interest. If this 55% ownership position allows the acquiring company to cancel the supply contract, the settlement loss would most likely be based on 60% of the unfavorable position (i.e., the favorable contract position surrendered by the other shareholders). Conversely, if the company is not able to cancel the supply contract, the loss would most likely be based on the 15% position purchased (i.e., the other shareholders would still realize value for the 45% interest they retained).

Reacquired rights

Rights previously granted to use intangible assets (e.g., trade name under a franchise agreement or rights to technology under a licensing agreement) should be recorded as an identifiable intangible asset if reacquired in a business combination. When estimating the fair value, the staff stressed that the acquirer should assume that it did not previously own the rights. For example, if a company acquires a restaurant that was previously a franchisee – thereby reacquiring the franchise right – the company should consider all of the factors that drive the value of the restaurant when determining the value to assign to the franchise right. Although intuitively it may seem that a mature franchise right would be worth more than a new franchise right, the restaurant’s additional value may be

due to other assets such as customer relationships, appreciated real estate or a strong work force.

Although EITF No. 04-1 does not specifically address the life over which such assets should be amortized, it states that it is appropriate to recognize a reacquired right as part of a recognized intangible asset. The SEC staff believes this is an indication that the life of the reacquired right would be the same as the life used for the acquirer’s existing intangible asset. In situations where there are limitations on the life of the reacquired right (e.g., a five year license with no renewal provisions) practice appears to be mixed, with some amortizing over the total product life cycle and others over the remaining years under the initial contract that created the rights. Although the SEC staff did not express a preference for either method they did note that the latter approach is consistent with the exposure draft for the replacement of SFAS No. 141.

New Basis of Accounting

With mergers and acquisitions on the rise, the SEC staff has been addressing a number of questions involving whether or not a change in ownership should result in a new basis of accounting. This issue can arise in two ways -- either from the perspective of the existing operating company (usually referred to as OLDSCO) that undergoes a change in ownership or from the perspective of a newly formed entity (usually referred to as NEWSCO) that just acquired an operating company. The SEC staff provided a general overview of the accounting guidance that is applicable in each scenario.

OLDSCO accounting

Under Staff Accounting Bulletin (SAB) Topic 5-J, *Push Down Basis of Accounting Required in Certain Limited Circumstances*, when a purchase transaction results in an entity becoming substantially wholly owned, a new basis of accounting for the assets and liabilities is created and required to be “pushed down” to the acquired entity’s stand-alone financial statements. EITF Topic D-97, *Push-Down Accounting*, expanded the guidance by clarifying that a new basis of accounting could also be required in situations involving a group of new investors. Specifically, if new investors “mutually promote” the acquisition and “collaborate on the subsequent control,” their holdings should be aggregated for purposes of analyzing the magnitude of the change in ownership.

There is a presumption – although rebuttable -- that investors who invest at the same time or in reasonable proximity to one another are part of a collaborative group, whose holdings should be aggregated. But EITF Topic D-97 does provide a number of factors that may indicate that aggregation is not appropriate. The staff cautioned that no one factor is more important than another and that the factors should be considered in their totality when concluding on the appropriateness of aggregation.

The SEC staff also suggested that registrants consider the following additional questions when analyzing the relationships:

- How did the investors come together to make the investment?
- Hypothetically, if one of the investors backed out of the deal, would the deal still have been done?

- How are the board seats determined and can the number of seats change over time?
- What is the nature of the decisions that require the unanimous or majority approval of all investors?
- What evidence supports that sales restrictions are considered reasonable and customary?

NEWCO accounting

The SEC staff cautioned that the guidance discussed above is only applicable when considering the accounting for an existing operating entity that undergoes a change in ownership. Such guidance, even by analogy, would not be appropriate when addressing the accounting for a newly formed entity. In these situations, EITF No. 88-16, *Basis in Leveraged Buyout Transactions*, should be followed for transactions that meet its stringent scope requirements (e.g., amount of debt, form of the transaction, the role of NEWCO, etc.) If EITF No. 88-16 is not applicable, transactions should be accounted for under SFAS No. 141.

Revenue Recognition

Breakage

In certain arrangements, even though customers make nonrefundable payments for future goods or services, they may not demand full performance from the vendor. For example, even though customers prepay when purchasing gift cards, a portion may go unredeemed. The accounting issue in such situations is when the vendor should recognize revenue for the unredeemed portion (commonly referred to as “breakage”).

In the past, the staff has stated that revenue recognition was appropriate either (a) when the vendor is legally released from its obligation

(e.g., at redemption or expiration) under criteria outlined in SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, or (b) when the vendor can demonstrate that it is remote that the customer will require performance.

More recently, the staff addressed a situation where the vendor was able to reasonably and objectively estimate the percentage of gift cards that would not be redeemed. Since no specific vendor performance would be required for this unused portion, the company believed that the amount of gift card breakage should be immediately recognized as revenue. The SEC stated that in such situations the vendor was still required to perform under the gift card arrangement (although arguably for an amount less than the full value of the gift card). Since the vendor had not performed as of the sale date, the delivery criterion for revenue recognition had not been met and revenue recognition was inappropriate.

However, the staff did suggest an alternative approach based on estimated redemption periods. If a vendor can reasonably and objectively determine the period over which actual gift cards will be redeemed (i.e., treat gift cards sold over a certain period of time as a homogenous pool) the estimated value of gift cards expected to go unused could be recognized as revenue on a pro rata basis over the performance period as the remaining gift card values were redeemed.

Software

If vendor specific objective evidence does not exist for all elements within a multiple element arrangement, the appropriate revenue recognition (both method and timing) under Statement of Position (SOP) 97-2,

Software Revenue Recognition, is predicated on the nature of each undelivered element. The general rule is that no revenue may be recognized until (a) vendor specific objective evidence exists for all elements or (b) all elements have been delivered, whichever is earlier. However the SOP does provide for certain exceptions under which revenue recognition may be accelerated.

The staff stated that some companies are applying these exceptions more broadly than originally intended and cited the following examples:

Post contract support (PCS). If the only undelivered element is PCS (which as defined includes “unspecified” upgrades) the entire fee is recognized ratably over the contract term. But if a vendor promises to deliver future upgrades (even where no features or functionality are specified) the staff believes this undelivered element must be considered “specified” upgrades. As such, if vendor specific objective evidence is not available (e.g., such upgrades have not yet been developed) deferral of the entire contract would be required.

Subscription. If an arrangement is in substance a subscription (i.e., vendors agree to deliver future unspecified software products over a specified period), the entire fee should be recognized ratably over the subscription period. The staff cautioned that subscription accounting is not an automatic alternative for companies that do not meet the requirements for upfront revenue recognition and should only be applied if the criteria for a subscription arrangement have been met.

Services. If the only undelivered element is services (not involving sig-

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nificant modification or customization) the entire fee should be recognized over the expected service period. Some registrants have bundled PCS and services into one undelivered element (i.e., attempting to analogize to a subscription arrangement) and recognized the fee ratably over the contractual period. Such an approach would only be appropriate if the PCS and services begin and end at the same time (i.e., essentially cover the same periods).

Share-Based Payments

The SEC staff stated that SFAS No. 123R, *Share-Based Payment*, requires companies to use significant judgment in determining estimates and valuations and acknowledged that fair value is not a forecast of actual future events. As such, if companies make good faith estimates and use reasonable judgment, subsequent changes in an award's value should not call into question the reasonableness of the initial fair values. The staff did, however, identify a number of factors that should be considered when developing the assumptions used in valuation methods and addressed some accounting and disclosure issues.

Expected volatility

Volatility is the measure of change in a financial variable (e.g., company's share price) over a period of time. The input measure used in valuation models should represent the expected volatility that *marketplace* participants would likely use in determining the exchange price for an option. The SEC staff believes that the following two methods of computing historical volatility do not meet this objective:

- Weighing the most recent periods much more heavily than earlier periods
- Using the average of the daily high and low share prices

Implied volatility relates to traded options and reflects the market's consensus regarding changes in a company's share price during the option term. As such, it would generally be a strong indicator of expected volatility. But traded options usually have a shorter life (typically two years or less) than employee options and, as a result, companies have been hesitant to use implied volatility for valuation purposes. The staff clarified in SAB Topic 14, *Share-Based Payment*, that the implied volatility of a traded option with a term of at least one year should not differ significantly from the implied volatility derived from a traded option with a longer term.

Expected term

Although various sources of information – company historical data, industry averages, or academic research – may be used when developing estimated lives, some companies have expressed concerns that relevant publicly available information does not currently exist and/or that historical data may not always provide appropriate information. As a result, the staff introduced a “simplified” method for estimating the expected term for “plain vanilla” options whereby the estimated life is computed as the average of the original contractual term and the vesting term. For example, an option with a ten year original contractual term and graded vesting over four years (25% of the option vests annually) would result in an expected term of 6.25 years (i.e., average of contractual term of 10 years and average vesting term of 2.5, which is

based on vesting terms of 1, 2, 3 and 4 years for each individual tranche).

This method may be used by public companies as well as companies going public (i.e., prior year financial statements in an initial registration statement) for options granted through December 31, 2007. At that time the staff expects more detailed information about employee exercise behavior to be available.

Requisite service period

Compensation cost for share-based payment awards should be recognized over the “requisite service period,” which is the period during which an employee is required to provide service in exchange for an award. Since the key factor is the requirement to provide future services, the implications of any unique features (e.g., continuation of vesting or non-compete clauses) should be carefully considered when determining the appropriate period.

For example, certain plans allow an employee to continue to vest in an award after the employee is no longer providing service (e.g., has retired). If such an award is granted to a retirement-eligible employee (i.e., an employee who is currently eligible to retire) the fair value of the award should be immediately recognized at the grant date. Since the employee can retire without losing the award, there is no requirement to provide future services.

This same principle was applicable under both SFAS No. 123, *Accounting for Stock-Based Compensation*, and APB Opinion No. 25, *Accounting for Stock Issued to Employees*. Nevertheless, in the past some companies have recognized compensation cost over the stated vesting period. Upon adoption of SFAS No. 123R, companies should apply the requisite service period guidance discussed above for new or modified awards.

Compensation cost for awards granted prior to the adoption of SFAS No. 123R should continue to be recognized over the remaining vesting period.

Similarly, the provisions of certain share-based payment awards that are fully vested at grant date may include non-compete agreements. Some have argued that even though there is no “explicit” requirement for the holder to continue to provide services in order to vest, the clause creates an “in-substance” requisite service period. This is an argument based in part on the conclusions reached in Illustration 16 of SFAS No. 123R.

The staff cautioned that the “in-substance” conclusion reached by the Board was based on a consideration of all the facts and circumstances and a determination that in that specific fact pattern the employee was essentially in the same position as if a stated substantive vesting period existed. The staff indicated that it does not believe that such a conclusion will be a common occurrence. When assessing the possible impact of a non-compete agreement on the requisite service period, the staff stressed that all specific facts and circumstances should be considered, including:

- The terms of the share-based payment award
- The terms of the related non-compete agreements
- The company’s past practice in enforcing non-compete agreements
- Past employee actions in response to non-compete agreements, if applicable

Required disclosures – pre and post adoption

Adoption of SFAS No. 123R may result in significant differences in the

financial statements for periods before and after adoption. Companies should ensure that the disclosures adequately convey to users the transition the company has undergone and the financial statement impact of these differences in the past, present, and future. For example, companies may refine certain estimates or assumptions as a result of changes in specific facts and circumstances or a more in-depth analysis of the underlying information. Although such changes may be appropriate, companies should explain the reasons for, and the effects of, such changes.

Similarly, SFAS No. 123 states that significant modifications to the terms of outstanding awards must be disclosed. As such, companies need to disclose any modifications that are made in anticipation of adoption of SFAS No. 123. Additionally, the SEC staff believes that such disclosure should also clearly highlight the reasons for the change. For example, if a company accelerates the vesting of awards prior to adoption of SFAS No. 123R to avoid future compensation charges in periods after adoption this reason must be clearly disclosed.

Under Article 10 of Regulation S-X, registrants may presume that users of interim financial information have access to the previous fiscal year audited financial statements and streamline the required disclosures accordingly. However, users cannot refer to previous filings and disclosures when a new accounting standard is adopted in an interim period. As such, the staff reminded registrants that the interim financial statements in the period of adoption must include all *annual* financial statement disclosures required under SFAS No. 123R. We believe that such disclosures should be

included in each quarterly filing in the year of adoption.

After adoption of SFAS No. 123R, some companies may want to disclose a measure such as “net income before share-based payment charge.” Since such a measure would essentially eliminate a “recurring” item, the staff stated that disclosure would only be appropriate if the requirements outlined in Question 8 of *Frequently Asked Questions Regarding the Use of Non-GAAP Financial Measures* (FAQ) have been met. Although the FAQ does not specifically prohibit such disclosure, the burden lies with companies to demonstrate the usefulness of any measure that excludes recurring items. When making this assessment, companies must be able to demonstrate that the measure is used internally to evaluate performance. The fact that the measure may be used by others to evaluate the performance of the company would not be sufficient. And if the hurdle is overcome and the other conditions outlined in Item 10(e) of Regulation S-K have been met, the staff reminded registrants that the measure must be accompanied by the disclosures required by the FAQ and listed below:

- How the non-GAAP measure is used by management in conducting or evaluating the business
- The economic substance behind management’s decision to use such a measure
- The material limitations when using the non-GAAP measure and how management compensates for these limitations
- The substantive reasons why management believes the non-GAAP measure provides useful information to investors

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Classification outside of equity

Section 211, *Redeemable Preferred Stocks*, of the Codification of Financial Reporting Policies (FRR 211) and the related interpretations and clarifications in EITF Topic D-98 require equity instruments to be classified outside of permanent equity if the instruments are redeemable (a) at a fixed or determinable price on a fixed or determinable date, (b) at the option of the holder, or (c) upon the occurrence of an event that is not solely within the control of the issuer. This guidance is applicable to share-based payment arrangements (vested as well as unvested).

Most awards with redemption features outside the control of the issuer are required to be classified as liabilities under SFAS No. 123R. However, for awards that contain redemption features and are not classified as liabilities, registrants must determine whether classification as mezzanine equity is required. If reclassifications are required, they should be made concurrently with the adoption of SFAS No. 123R.

Embedded Conversion Options

Accounting for embedded conversion options is a prime example of the current complexity in GAAP. The current guidance, which exists in a litany of FASB pronouncements, EITF consensuses, and SEC staff interpretations, is not only complex but oftentimes contradictory. No roadmap exists to address the inconsistencies that exist among these various sources of GAAP or to suggest the order in which they should be applied.

Not surprisingly, the staff believes that many registrants are improperly accounting for conversion options embedded in convertible debt and

convertible preferred stock. These errors are often the result of undisclosed features or the application of the wrong guidance. For example, the staff noted that many companies account for beneficial conversion features under the intrinsic value model outlined in EITF Issue No. 98-5 and EITF Issue No. 00-27, *Application of EITF Issue No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios," to Certain Convertible Instruments*, without first considering whether the instrument should be accounted for at fair value under SFAS No. 133.

The SEC staff provided the following "simplified" guide when evaluating the accounting for embedded conversion options:

Step One. A company should determine whether the embedded conversion option must be separated from the host contract under SFAS No. 133. Since most embedded conversion options meet the general definition of a derivative, the focus should be on whether the exception to bifurcation outlined in paragraph 11(a) applies. Specifically, if an instrument is both (a) indexed to a company's own stock and (b) classified in stockholders' equity, it does not need to be bifurcated and accounted for separately.

Step Two. A company should refer to EITF No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*, to determine if the embedded conversion option – if it were a free-standing derivative – would be classified as liability or equity. However, similar to SFAS No. 133, EITF No. 00-19 provides a scope exception for instruments that qualify as "conventional convertible debt."

Step Three. A company should consider EITF No. 05-2, *The Meaning of Conventional Convertible Debt Instruments in Issue No. 00-19*, to determine if the instrument qualifies as conventional convertible debt. If the debt qualifies as conventional, the criteria for distinguishing between liability and equity in EITF No. 00-19 do not apply and do not need to be considered.

In essence, the major considerations when analyzing the accounting for embedded conversion options should be (a) whether or not the instrument is conventional convertible debt and (b) if not, whether a freestanding instrument with characteristics similar to the embedded option would be considered a liability or equity instrument under EITF No. 00-19.

If the embedded conversion option would be equity if it were free-standing (e.g., the instrument is conventional convertible debt or the embedded option would be equity under EITF No. 00-19 criteria), the instrument should be reviewed for a beneficial conversion feature under the intrinsic value model based on the guidance in EITF No. 98-5 and EITF No. 00-27. Conversely, if a free-standing instrument with similar characteristics would be a liability, the conversion option must be bifurcated from the host contract and accounted for at fair value under SFAS No. 133.

Conventional convertible debt

As defined in EITF No. 05-2, conventional convertible debt is an instrument "in which the holder may only realize the value of the conversion option by exercising the option and receiving the entire proceeds in a fixed number of shares or the equivalent amount of cash (at the discretion of the issuer)." When ana-

lyzing the provisions of a contract, the staff advised registrants to pay particular attention to the underlined phrases and provided examples of how various contractual provisions should be analyzed in light of these strict criteria:

A fixed *conversion rate* (e.g., \$12 per share) meets the criteria since the entire proceeds would be received in a fixed number of shares. Conversely, an instrument that includes a conversion price that varies (e.g., based upon the stock price or percentage of the stock price at the conversion date) would not be conventional since the number of shares to be issued will vary based on changes in the stock price.

A *reset provision* adjusts the conversion price under certain conditions. For example, an agreement might state that if shares are later sold at a price below the conversion price, the conversion price will be adjusted to the price of the subsequent sale. Such a provision would prohibit consideration of the instrument as conventional since the number of shares to be issued may change. The SEC staff also stressed that the issuer's control over the triggering events (e.g., subsequent sale) and the likelihood of the price reset occurring are not relevant. If the number of shares to be issued upon conversion may change based on a contingent event, regardless of probability, the instrument is not conventional.

A *holders' inability to immediately exercise* a conversion option does not impact the assessment regarding fixed number of shares. For example, an agreement may allow the holder to convert into a fixed number of shares any time after the earlier of (a) the passage of one year or (b) the completion of a secondary share offering. The criteria for a fixed number of shares would be met

despite the fact that the holder cannot immediately exercise the conversion option.

An instrument may require the company to settle the conversion option in part cash and part shares. For example, a \$1000 debt instrument with a \$5 conversion rate (200 shares) may require the company to settle with \$1000 in cash and with shares equal to the difference between the fair value of the shares at the conversion date and \$1000. Since the *entire amount* is not *paid entirely in shares or cash* this instrument would not meet the definition of conventional.

Registration rights and liquidating damages

Convertible debt and warrants are commonly accompanied by an agreement to register the underlying shares (i.e., registration rights agreement). Typically, such an agreement requires the registrant to use its best efforts to register the underlying shares by a specified date and imposes liquidating damages if the deadline is not met.

Liquidating damages are one of the contractual provisions considered in EITF No. 00-19 when assessing whether liability treatment is required. When analyzing such clauses, the SEC staff focuses on whether the potential liquidating damages represent a reasonable estimate of the difference in fair value between registered and unregistered shares. If the damages approximate this fair value difference, the staff assumes that the registrant could choose to settle in unregistered shares and pay the damages since this would cost no more than delivering registered shares. As such, this clause would not require liability accounting.

However, if the damages exceed the fair value differential, settlement

with unregistered shares would not be economically advantageous from the perspective of the registrant. In this situation, the staff assumes that the registrant would settle in cash, even if no cash settlement provision is present, since the ability to register the shares is outside the control of the registrant. Such a situation would result in the conversion options or freestanding warrants being classified as liabilities and accounted for at fair value under SFAS No. 133.

Sufficient authorized and unissued shares

Another provision addressed in EITF No. 00-19 is whether a registrant has sufficient authorized and unissued shares available to settle conversion options or freestanding warrants after considering all other commitments that may require the issuance of stock. If the number is insufficient, a registrant must assume that it will be required to settle in cash and the instruments must be accounted for as liabilities at fair value under SFAS No. 133. The staff discussed some common misapplications of this provision.

If the number of shares that could be issued to settle an instrument is not capped, a company cannot conclude that it has sufficient authorized shares available to settle in shares. For example, a company may issue \$20 million of debt that can be converted at any time into common stock based on a conversion price equal to the lower of \$5 per share or 80% of the share price at the conversion date. Under such a provision, the number of shares that the company could be required to issue increases significantly as the share price declines (e.g., 2 billion shares would be required to for settlement if the conversion price drops to \$.01).

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A single contract that fails to limit or cap the number of shares that might be required to be issued taints all other contracts. The company cannot conclude that it has sufficient authorized and unissued shares to settle *any* of its outstanding contracts. All derivatives, whether embedded or freestanding, under all contracts would need to be considered liabilities and accounted for under SFAS No. 133.

The SEC staff emphasized that when analyzing a particular contract for sufficiency of shares a registrant must consider all instruments that could be settled in shares. This analysis should include all other commitments that may require the issuance of stock, including employee options and other embedded and freestanding derivatives.

The SEC staff encouraged companies to thoroughly review the terms and provisions in all of their agreements to identify any embedded derivatives. Registrants should also expand their disclosures to describe all embedded derivative features (e.g., reset provisions), how those features were considered in analyzing the appropriate accounting, and the basis for concluding whether fair value accounting was or was not appropriate.

Materiality

In practice, there are currently two methods for assessing the materiality of errors. The “rollover” approach focuses on the income statement and quantifies an error as the amount by which the current year income statement is misstated. Under the “iron curtain” approach, the focus is on the magnitude of the misstatement to the current balance sheet. For example, if a liability is overstated by \$80 in the prior year

and by \$100 in the current year, the error in the current year would be \$20 under the rollover method and \$100 under the iron curtain method.

The SEC staff does not believe that diversity in practice is appropriate for an issue as basic as determining the amount of the error. As a result the staff has spent considerable time deliberating – and continues to deliberate -- this issue. Although the current thinking is that quantifying errors using both approaches may be the better answer, no conclusions have been reached.

The SEC staff understands that a new approach to materiality cannot be implemented immediately and that registrants will need time to digest any new guidance. So in the meantime, until formal guidance is issued, the staff suggested that registrants do the following:

- Understand the approach currently being used for assessing materiality and ensure that it is used consistently throughout the company
- Consider the impact on future periods when evaluating errors and whether errors could cause future financial statements to be materially misstated (e.g., not straight-lining lease payments)
- Continually reassess whether a standard that was not adopted because it was not considered material is still immaterial
- Base any decision not to adopt a standard solely on its immateriality and not on the fact that its adoption would cause users to view the financial statements differently (which is evidence that the standard is in fact material)

The staff reminded registrants that an error that was immaterial in prior years, but material to the current year, cannot be corrected in the

current year if such correction would result in a material misstatement of the current year. In such cases, restatement of prior years’ financial statements would be required.

Segments and Reporting Units

Under SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, operating segments may only be aggregated if they meet two criteria. First, they must possess similar economic characteristics, which the SEC staff generally views as similar profitability measures such as gross profit margin or operating income margin. Second, they must have similar products or services, production processes, customers, distribution methods, and regulatory environments.

Despite the clear guidance in SFAS No. 131, the staff continues to see improper applications of the aggregation rules. Common errors cited by the staff include:

- Aggregating operating segments that do not share all of the aggregation criteria – particularly economic similarity
- Aggregating immaterial segments with a reportable segment that does not share a majority of the characteristics cited above rather than properly presenting immaterial segments in an “other” column

Under SFAS No. 142, *Goodwill and Other Intangible Assets*, goodwill is assessed for impairment at the reporting unit level, which is defined as either an operating segment under SFAS No. 131 or one level below (i.e., a “component”). The staff continues to see errors in identifying the reporting units and reminded registrants of the following:

- Components may only be aggregated into a reporting unit if (a) they have similar economic characteristics and (b) they are within the same operating segment as identified for purposes of SFAS No. 131.
- Reportable segments based on the aggregation of operating segments under SFAS No. 131 cannot be reporting units. For example, if 350 operating segments had been aggregated into one reportable segment for purposes of SFAS No. 131, there would be at least 350 reporting units under SFAS No. 142.

The staff also reminded companies that disclosures regarding reporting units should be clear and transparent. Although not specifically required by SFAS No. 142, companies should identify the reporting units, indicate how goodwill has been allocated to the reporting units, and disclose any changes made to either.

Statement of Cash Flows

Discontinued operations

Separate disclosure of cash flows relating to discontinued operations is not required under SFAS No. 95, *Statement of Cash Flows*. However, if a company voluntarily chooses to segregate such cash flows, the SEC staff believes the presentation must conform to the basic requirement of SFAS No. 95. That is, cash receipts and cash payments must be classified in three categories -- investing, financing, or operating activities.

If a company chooses to separately disclose discontinued operations, the SEC staff believes it can do so by:

- Separately identifying the cash flows within each of the three categories, or
- Identifying the cash flows for each category and presenting them separately near the end of the statement (before the increase/decrease in cash)

Aggregating all cash flows from discontinued operations in a single line item as a separate fourth category or presenting all cash flows from discontinued operations (including those related to investing and financing activities) within the operating cash flows category is not acceptable.

The staff also reminded registrants that if the indirect method is chosen under SFAS No. 95, net income – not income from continuing operations – should be reconciled to cash flows from operating activities. Additionally, management's discussion and analysis (MD&A) should describe how cash flows from discontinued operations have been reported in the cash flow statement; quantify the cash flows from discontinued operations if not separately disclosed in the statement; and describe how the loss of cash flows from discontinued operations is expected to impact future liquidity and capital resources (e.g., effect on financing levels, terms, covenants, etc.).

Dealer floor plan financing

Dealers often finance their inventory purchases through floor plan arrangements. The classification of cash flows in these situations depends on who is providing the financing and whether or not there is a relationship between the financing arm and the vendor. For example, if the supplier or one of its subsidiaries finances the dealer's purchase (i.e., seller financing) the dealer should classify the cash flows related to the trade loans within

operating activities. Conversely, if the financing is arranged through an independent third party, the dealer should classify cash flows related to loan issuances and repayments within financing activities.

Insurance claims

Similarly, the nature of insurance coverage determines the classification of insurance claim proceeds in a statement of cash flows – not the expected use of the funds. Specifically:

- Proceeds under a business interruption claim should be classified as an operating activity
- Proceeds for property damage or loss should be classified as an operating activity if the claim related to property, plant, and equipment that had been accounted for under an operating lease
- Proceeds for property damage or loss should be classified as an investing activity if the property, plant, and equipment was either owned or recorded under a capital lease

In all cases, MD&A should address all material insurance settlements and disclose the amounts received and why, management's plans for the funds, the classifications in the statement of cash flows, and the impact on earnings.

Retained interests in securitized loans

A company may exchange loans or trade receivables for retained interests in securitized loans. This initial exchange would not be included in a cash flow statement, but supplemental disclosure of this non-cash investing activity may be warranted. The classification of the true cash inflows, namely subsequent principal payments on the retained interests, depends on how the company

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accounts for the retained interests. For example, if the retained interests are accounted for in a manner similar to trading securities (as addressed in SFAS No. 115), the payments should be classified within operating activities. Conversely, if the retained interests are accounted for in a manner similar to available for sale or held to maturity securities, the cash flows should be classified within investing activities.

Assessing Hedge Effectiveness

To qualify for hedge accounting under SFAS No. 133, companies must generally perform on-going assessments of the effectiveness of a hedge, both prospectively and retrospectively. However, under an exception available for certain “straightforward” hedges of interest rate risk (e.g., interest rate swaps and recognized interest-bearing assets and liabilities) companies may assume no ineffectiveness in a hedging relationship. Known as the “shortcut method,” this exception is only available to companies that meet all the general hedge requirements (e.g., contemporaneous formal documentation) as well as nine additional criteria specific to shortcut method hedges.

The SEC cautioned registrants that all criteria must be met in order for companies to avail themselves of the shortcut method and provided examples where the shortcut method is not appropriate:

- If companies only comply with the “spirit” of the method and not with all of the specific criteria.
- If an interest rate swap includes a financing element (e.g., adjustments to the “pay” or “receive” leg of the swap in lieu of paying certain upfront transaction fees)

and therefore has a fair value other than zero at inception.

In the periods in which the shortcut method has been inappropriately applied, the magnitude of the error must be assessed. Some have suggested that in such situations the amount of the error should be the amount of ineffectiveness that would have been recognized under the general hedge accounting guidance in SFAS No. 133. The SEC staff disagrees with this approach since most registrants who apply the shortcut method do not also perform the prospective and retrospective testing of hedge effectiveness required under SFAS No. 133. The staff stressed that the error should be quantified on the basis that hedge accounting was not available at all (e.g., for a cash flow hedge the error would be the change in fair value that should have been reflected in the income statement).

Implicit Variable Interests

FASB Staff Position (FSP) No. FIN 46(R)-5, *Implicit Variable Interests under FASB Interpretation No. 46(R)*, states that a variable interest that absorbs the variability of an entity indirectly, rather than through contractual interests in the entity, is an “implicit” variable interest. The FSP provides as an example, a company that leases an asset from an entity that is owned entirely by a related party. The lessee would hold an implicit interest in the lessor company if it effectively guaranteed the related party’s investment.

Although the FSP focuses on non-contractual arrangements with related parties, the staff stated that implicit variable interests could also result from contractual arrangements with unrelated variable interest holders. For example, a company with no

direct contractual interest in a variable interest entity (VIE), may enter into contractual agreements with several unrelated variable interest holders in that entity that effectively protect those holders from absorbing a significant amount of the entity’s variability. Since the company is absorbing the negative variability in the VIE through these agreements, the company would have an implicit variable interest. Additionally, if it absorbs a majority of the expected losses, it would be considered the primary beneficiary under FIN 46(R), *Consolidation of Variable Interest Entities*.

The staff suggested that registrants consider the following questions when evaluating whether an implicit variable interest exists:

- Was the arrangement entered into in contemplation of the entity’s formation?
- Was the arrangement entered into contemporaneously with the issuance of a variable interest?
- Was the arrangement entered into with a variable interest holder instead of the VIE?
- Did the arrangement refer to specified assets of the VIE?

Loans Held for Sale

Statement of Position (SOP) 01-6, *Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others*, provides guidance on classification and accounting for loans held for sale and loans held for investment. Although portions of the SOP focus on finance companies, the SEC staff reminded registrants that the SOP applies to any entities (including non-finance companies) that engage in transactions that involve lending to, or financing the activities of, others. As such, SOP 01-6 is applicable to all

companies – regardless of industry – that are selling, or contemplating selling, their trade receivables.

Under SOP 01-6, loans and trade receivables should be accounted for as held for investment if management has both the intent and the ability to hold the receivables for the foreseeable future or until maturity. Conversely, loans and trade receivables that management intends to sell outright or through a securitization should be accounted for as held for sale.

Loans and trade receivables held for sale should be measured at the lower of cost or market and reported separately on the balance sheet. Additionally, companies should disclose their policies for determining (a) when such receivables should be classified as held for sale and (b) the lower of cost or fair value.

Income Statement Geography

There is no current overall framework for classifying transactions in an income statement. Guidance, to the extent it exists, is very specific in nature and captured in various SEC rules (e.g., Rule 5-03 of Regulation S-X) and GAAP (e.g., Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements* and various EITF Consensuses). As a result, when assessing classifications, the staff recommended that registrants analogize to existing literature and be consistent in their applications. The staff also provided the following additional thoughts and guidance:

- Gross versus net revenue – although written in the context of internet-based companies, EITF Issue No. 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent*, applies to all com-

panies. Identifying and focusing on the ultimate customer is helpful when analyzing the various factors to consider.

- R&D reimbursements – reimbursements may generally be presented as either revenue or reductions to expenses. The key is for a company to disclose its policy and be consistent in its application.
- Vendor taxes – when determining whether to use gross up or pass through presentation, registrants should consider who is ultimately responsible for payment of the taxes (e.g., who is obligated for payment of sales taxes). Specifically, net presentation would seem reasonable for customer obligations and gross presentation if the vendors are ultimately responsible.
- Amortization of intangible assets – the classification as to cost of sales or SG&A should be based on the function and use of the intangible asset (e.g., if directly related to a revenue generating activity, cost of goods sold would seem to be appropriate). The presentation should also comply with SAB Topic 11-B, *Depreciation and Depletion Excluded from Cost of Sales*.

International Reporting Issues

The SEC staff meets periodically throughout the year with the AICPA International Practices Task Force, a subcommittee of the AICPA SEC Regulations Committee. The purpose of the task force is to address issues facing foreign private issuers on a timely basis as they arise in practice. Minutes of the meetings, including discussions and conclusions reached, are available at the

AICPA's website at www.aicpa.org/belt/sec-hl.htm. Additionally, *International Reporting and Disclosure Issues in the Division of Corporation Finance*, updated as of February 2005, is also available at the SEC's website at www.sec.gov/divisions/corpfin/international/issues1004.htm. Registrants are encouraged to take advantage of these valuable resources.

International financial reporting standards (IFRS)

IFRS, which were adopted by many companies in 2005, requires that the standards be retrospectively applied for the two most recent years. Since Form 20-F requires three years of audited financial statements prepared on a consistent basis of accounting, the SEC adopted a rule that would allow first-time IFRS adopters to provide only 2 years of audited IFRS financial statements. This accommodation, however, is not universal and comes with a number of conditions. Namely:

- US GAAP reconciliations must be presented for the two fiscal years.
- The accommodation is only available to first-time adopters as defined in IFRS 1 and only through fiscal year 2007.
- Financial statements must either (a) comply fully with IFRS or (b) comply with IFRS as adopted by the EU and, if the latter, include reconciliations to full compliance with IFRS for the two years (including all disclosures).

This accommodation is also available for financial statements of other entities meeting the definition of a foreign business, including those required for acquired or target businesses (Rule 3-05 of Regulation S-X), equity method investees (Rule 3-09), guarantors (Rule 3-10), and collateral entities (Rule 3-16).

As a result of the international efforts devoted to convergence of

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GAAP, many of the IFRS standards – and underlying principles – are consistent with those of US GAAP. Nevertheless, from a GAAP reconciliation perspective, many differences will continue to exist because of different adoption dates (e.g., pension plans adopted in the 1980s under US GAAP and now under IFRS). Some have suggested that the GAAP reconciliation should focus on fundamental differences in GAAP (not transitional timing differences) and that a one-time accommodation should be made in the reconciliation for current standards that are essentially identical. The accommodation envisioned would have allowed registrants to change the application of accounting principles historically followed under US GAAP to the application of accounting principles consistent with IFRS. The SEC staff disagreed with this approach and indicated that such accommodation will not be forthcoming. The staff stressed that the reconciliation should describe in detail the reasons for, and nature of, these “transitional” differences.

For more guidance regarding the adoption of IFRS, registrants should refer to the minutes of the May 2005 AICPA International Practices Task Force, where topics including eligibility, registration statements in the transition year, exceptions mandated or permitted by IFRS 1, EU GAAP matters, other disclosures, and furnished information were discussed.

Accelerated filer

Foreign private issuers are no longer exempted from the definition of

accelerated filer. As such, foreign companies that meet the criteria as of a fiscal year end would be considered accelerated filers. However, the SEC staff stressed that from a practical standpoint an accelerated filer designation would only impact the implementation date for 404 reporting. Such a designation would not impact periodic filing deadlines, since the SEC does not intend to accelerate the due dates for the annual reports filed under Form 20-F. But if foreign private issuers voluntarily choose to file on domestic forms (e.g., Form 10-K), they must comply with the accelerated domestic filing deadlines.

The staff also emphasized that for purposes of assessing public float the definition is the “aggregate worldwide value” of the company’s common equity held by non-affiliates. Additionally, since public float is based on common equity, a company that has only public debt would not meet the definition of an accelerated filer.

Further Interpretation of Accounting Pronouncements

The SEC staff also provided insight into how they interpret and apply certain accounting pronouncements. The following recap has been provided as a quick reference tool:

- Companies may consult with their auditors (including the firm’s national office) on complex accounting matters without any adverse consequences. Independ-

dence issues and 404 concerns would only arise if companies “rely” solely on their auditors.

- There is no matching principle (e.g., matching of expenses with particular revenues) under US GAAP. Rather, the focus is on the balance sheet and the income statement is simply a reflection of the changes in the values of the assets and liabilities.
- Rising interest rates may require debt instruments to be considered other than temporarily impaired if the company does not intend, or have the ability, to hold the instruments until recovery.
- Identifiable intangible assets for customer relationships may be identified under SFAS No. 141 even if no contract or formal arrangement exists at the consummation date.
- For purposes of estimating fair values, a new public company should continue to use the volatility of similar entities until it has sufficient history of its own.
- Since holders may sell shares once the holding periods under Rule 144A have been met, Rule 144A can be considered a cap on liquidating damages when assessing liability versus equity classification under EITF No. 00-19.
- Companies cannot rely on another registrant’s comment letter as precedent since each letter is based on specific facts and circumstances.

Material discussed in this *Financial Reporting* letter is meant to provide general information and should not be acted upon without first obtaining professional advice appropriately tailored to your individual circumstances.