



# SEC Insights

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Frequently, the staff of the Securities and Exchange Commission develops informal views about accounting and reporting issues. The staff communicates its views in a number of ways. Often, the staff communicates them broadly through speeches, particularly at the AICPA National Conference on Current SEC and PCAOB Developments held each December in Washington, D.C. Sometimes, the staff’s views become known through more subtle means, such as discussions with registrants and filing reviews. The purpose of this letter is to provide you with insight into the staff’s views and concerns regarding several matters that will be of particular importance this reporting season. The letter also provides insight into the PCAOB staff’s views on a related issue that has concerned many people: how a company consulting with its auditor on accounting matters affects its ability to report effective internal control.

The letter covers these matters in two sections:

- SEC and financial reporting issues
- Accounting issues

Our *Financial Reporting* letter, *SEC Year in Review – Significant 2004 Developments*, which is available on our website (<http://www.bdo.com/about/publications/assurance/>), provides background and additional information regarding some of the SEC reporting issues.

### SEC and Financial Reporting Issues

#### Improving Financial Reporting

While the SEC staff believes that progress is being made in improving financial reporting, they believe there is still much room for further improvement, particularly with regard to providing disclosures that are more transparent and understandable. In their view, part of the reason for this may be that companies too often view financial reporting as a compliance exercise, when it should instead be viewed as a communication exercise. As a result, disclosures often fail to provide sufficient information and are poorly organized. The staff encourages preparers to ask themselves whether, if they were independent investors using their financial reports, they would have the information they would need to make an investment decision. If not, the quality of the communication should be improved. This may require preparers to adopt the mindset that the Commission's rules and the requirements of GAAP are the "floor" or the starting point for good disclosure, not the ceiling. The staff believes that companies can and should be able to provide robust, transparent disclosures without additional rules, and the staff challenges companies to do so.

In speeches, the staff has focused on a number of areas where companies could consider changes in reporting that, in the staff's view, would improve the quality of their financial reporting:

- *Report cash flows using the direct method* – FASB Statement 95 has a stated preference for the direct method of reporting cash flows. In addition, users have communicated their preference for this method.

Yet virtually all companies use the indirect method.

- *Eliminate the smoothing mechanisms in pension accounting* – The smoothing mechanisms permitted by FASB Statement 87 are not required, and many believe such methods allow for distorted reporting.
- *Disclose expense information by nature* – Regulation S-X requires companies to report expenses by function (cost of sales, selling expenses, etc.) on the face of the income statement. A supplemental presentation of expenses by nature (salaries, material purchases, depreciation, rent, etc.) would be informative and could be provided either in footnotes or in a table in MD&A.
- *Disclose meaningful information about asset lives* – Most companies disclose asset depreciable lives in broad ranges, such as "5 to 30 years." It would be helpful to provide more meaningful information, for example, how much of the fixed asset balance is depreciated over 5 years, how much is depreciated over 10 years, and how much is depreciated over 30 years.
- *Enhance MD&A by using tables and providing real insight* – If changes are presented in tables, the discussion can focus on the reasons for the changes.
- *Provide key performance indicators and relevant non-GAAP financial measures* – These can be essential to an understanding of a company's financial performance. (Of course, all non-GAAP measures included in an SEC filing must comply with Regulation G and Regulation S-K Item 10(e).)
- *Improve financial instruments disclosures* – The staff has found that disclosures regarding financial instruments, even when they

meet the minimum requirements, often do not communicate useful information to investors. They are often disjointed, explain only pieces of transactions, are spread all over the filing, and sometimes do not tie out to the financial statements. The staff encourages issuers to relate the various disclosures to each other and to the financial statements, so they present a more complete picture of the risks and arrangements that affect the company and the way those risks and arrangements have affected the financial statements, regardless of whether the disclosure needed to do so is required by any rule or standard.

#### Structured Transactions

"Structured" transactions are designed to achieve a particular accounting objective, often the opposite of the accounting sought by the principle underlying an accounting standard. Examples of such transactions include:

- Leases designed to avoid capital lease treatment under FASB Statement 13, *Accounting for Leases*.
- Financial instruments designed to avoid liability treatment under FASB Statement 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*.
- Special purpose entities designed to avoid consolidation under FASB Interpretation 46(R), *Consolidation of Variable Interest Entities*.

While the SEC staff recognizes that these transactions can "work" when they clearly comply with the accounting literature, they believe that they do not promote transparency and are not in the best interests of investors. Accordingly, the staff believes that if registrants consider it appropriate to structure

transactions around accounting standards, then they should be willing to plainly communicate the purpose of such transactions in their disclosures to investors. The staff frequently scrutinizes the accounting for structured transactions, and sometimes they find such transactions that do not fully comply with the accounting literature. When they do, the staff has little sympathy for a company that tried to circumvent the accounting literature but failed, yet wants to avoid a restatement.

### Internal Control Reporting

The SEC staff views reporting on internal controls pursuant to Section 404 of the Sarbanes-Oxley Act as the most urgent financial reporting challenge facing corporate America and the audit profession. While the staff is sensitive to the cost and effort that companies have invested in complying with the rules, they believe that stronger internal controls should reduce the number of restatements and therefore justify the costs of implementing the rules in the long run.

With respect to small, medium-sized, and less complicated businesses, the staff has encouraged the private sector to develop internal control guidance designed specifically to address their needs. The staff supports the plans of the Committee of Sponsoring Organizations of the Treadway Commission (COSO) to develop appropriate guidance for smaller companies. This guidance is expected to be completed by the summer of 2005. In addition, the staff intends to hold open dialogues in the spring of 2005 to consider best practices and how the process can be streamlined to ensure that investors are getting useful and relevant information in a cost effective manner. In that regard,

in December 2004, the Commission appointed an Advisory Committee on Smaller Public Companies, which will assist the Commission in examining the impact of the Sarbanes-Oxley Act and other aspects of the federal securities laws on smaller public companies.

As the deadline for reporting on internal controls draws near, the staff expects an increasing number of companies to announce that they have material weaknesses in their internal controls. The staff believes it is critical that companies provide complete, robust and transparent disclosure about material weaknesses. In that regard, they have made the following recommendations:

- *Don't try to "disguise" or "pretty up" material weaknesses* – Fully explain, in plain English, the weakness, how it impacts the preparation of the financial statements, and the remedial action that has occurred or is planned so investors can understand the nature and severity of the weakness.
- *Consider the impact of material weaknesses in internal control over financial reporting on disclosure controls* – Most of a company's controls that are part of its internal control over financial reporting are also part of its disclosure controls and procedures. Therefore, a material weakness in internal control will usually constitute a material weakness in disclosure controls and lead a company to conclude that it has ineffective disclosure controls as well as ineffective internal control over financial reporting. Furthermore, if a company has to restate prior period financial statements and this leads to the discovery of a material weakness in internal control, it will need to consider whether

previous disclosures provided pursuant to Regulation S-K Item 307 (i.e., reports on the effectiveness of the company's disclosure controls and procedures) must be modified, supplemented, or corrected. If the company concludes that its original Item 307 disclosures were incorrect, it should disclose this information when it files its Form 8-K to disclose the impending restatement of its financial statements.

In this initial year of internal control reporting, the staff believes that material weaknesses, when disclosed properly, should not prompt severe reactions by regulators or the market. Moody's Investors Service, the bond rating agency, has indicated that it will not view all material weaknesses in the same light. For example, a material weakness in controls over a specific transaction-level process, if it is a relatively narrow problem and can be audited around, will not be viewed as severely as a material weakness that has pervasive effects, such as an ineffective control environment or an ineffective audit committee.

The SEC has taken a number of actions to provide companies and auditors with more time to implement the internal control reporting requirements. These actions include deferral of the final phase-in of accelerated reporting deadlines for accelerated filers and an exemptive order providing a temporary, 45-day postponement of the filing date for internal control reports. The postponement is available to accelerated filers with fiscal year-ends between November 15, 2004 and February 28, 2005 and a public equity float of less than \$700 million as of the end of the company's second quarter. To take advantage of the postponement, a company must

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file its annual report with all required information except the internal control reports by the “regular” due date and may file the internal control reports by amendment up to 45 days later. If the company is aware of a material control weakness at the time of the initial filing of the annual report, it must disclose it in that filing.

After the Commission issued the exemptive order providing for the 45-day deferral, the staff addressed a number of implementation questions orally, and in January 2005, the staff issued guidance in the form of a frequently asked questions (FAQ) document. The FAQ document is available on the Commission’s website (<http://www.sec.gov/divisions/corpfin/faq012105.htm>). The staff’s views on key issues related to annual report amendments are as follows:

- *Controls evaluation date* – The order provides additional time for companies to file internal control reports. It does not change the date as of which a company must evaluate its internal controls (year-end).
- *Contents of amendment* – The annual report amendment must contain at least all of the information required by Item 9A of Form 10-K and Section 302 certifications. Item 9A, Controls and Procedures, requires the information about disclosure controls and procedures and internal control over financial reporting called for by Items 307 and 308 of Regulation S-K.
- *Item 307 and 308 disclosures* – The Item 307 report on disclosure controls and procedures and the Item 308(c) disclosures about material changes in internal controls included in the initial filing of the annual report may need to be revised if new material weak-

nesses are discovered when completing the internal control reports.

- *Section 302 certifications* – The certifications included in the original filing of the annual report may continue to omit the introductory language in paragraph 4 of the certifications related to internal control over financial reporting and all of paragraph 4(b) if the filing does not include internal control reports. This language must be included in the certification filed with the amendment to the annual report. The certification filed with the amendment must contain paragraphs 1, 2, 4, and 5, but paragraph 3 is not required if the amendment does not include financial statements.
- *Consents* – An annual report amendment will need an auditor’s consent to the incorporation by reference of the auditor’s report on internal control into previously filed registration statements if they incorporate subsequent Exchange Act filings by reference. The amendment will not require another consent to the incorporation by reference of the auditor’s report on the financial statements if the amendment does not include financial statements.

The FAQ also provides the staff’s views on questions about eligibility to use certain forms for the registration of offerings under the Securities Act and related matters during the period between the initial filing of the annual report and the time it is amended to include the internal control reports:

- *Filing Form S-2/S-3* – During this period, a company may file a registration statement on Form S-2 or S-3. However, it may not request effectiveness until the internal control reports have been filed.

- *Shelf takedowns* – During this period, a company may not offer and sell securities pursuant to an effective Form S-3 if the transaction is a capital raising transaction. However, offerings by selling security holders and offerings that represent dividend reinvestment plans or direct stock purchase plans will be permissible.
- *Form S-8 and Rule 144* – During this period, companies may use Form S-8 and selling security holders may rely on Rule 144.

Some companies may not be able to complete their internal control assessments and file the internal control reports by the applicable due date. The staff has requested that registrants that believe they will not be able to meet their filing deadline inform the Division of Corporation Finance of this as soon as possible so the Division can be aware of problems registrants are experiencing. Additionally, if the internal control reports will not be filed by the applicable due date and (i) management and the auditor agree that a material weakness exists or (ii) it is clear that the auditor will disclaim an opinion, the staff believes the company should report this information in a Form 8-K.

### Accounting Consultations

In June 2004, the PCAOB staff issued an FAQ document that provides guidance on applying PCAOB Auditing Standard 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* (AS 2). The FAQ document is available on the PCAOB’s website (a link is provided at: [http://www.pcaobus.org/Standards/Staff\\_Questions\\_and\\_Answers/index.asp](http://www.pcaobus.org/Standards/Staff_Questions_and_Answers/index.asp)). Question 7 emphasizes that a company must have effective internal control over financial reporting “on

its own.” This has raised concerns about whether a company consulting with its auditor on accounting matters would preclude it from being able to demonstrate that it has effective internal control.

The PCAOB staff has informally stated that AS 2 and question 7 were not intended to stop accounting discussions between companies and their auditors. The guidance in question 7 stating that the results of auditing procedures cannot be considered when evaluating a company’s internal control was meant to address situations in which management has relied on the auditor to identify misstatements in the financial statements and to propose corrections in amount, classification, or disclosure. It was not meant to discourage companies from talking to their auditors about complex accounting issues before the time a company reaches its conclusions about the appropriate accounting treatment. While those discussions may need to be more carefully structured than they have been in the past, the PCAOB staff did not intend to stop timely auditor consultation in applying complex and highly technical accounting pronouncements.

## Accounting Issues

### Contingencies

The SEC staff has expressed concern about registrants’ accounting and disclosure related to loss contingencies. The staff has seen a number of instances where no loss is recorded and no disclosure is made until the date a large charge is recorded.

- FASB Statement 5, *Accounting for Contingencies*, requires an accrual for the estimated amount of probable losses, and FASB Interpreta-

tion 14, *Reasonable Estimation of the Amount of a Loss*, provides that accruing the lowest amount of a range of possible losses is appropriate, but only when no amount within the range is more likely than the lowest amount. Thus, a higher amount (than zero) should be accrued if it is a better estimate of the loss. The staff is skeptical about the prior accounting when financial statements assert that zero was as likely as any other amount in periods shortly before recording a large charge.

- If a material loss is reasonably possible, Statement 5 also requires disclosure of the nature of a contingency, including the range of reasonably possible loss in excess of the accrual. In addition, the MD&A rules require discussion of uncertainties that are reasonably likely to materially affect a company’s liquidity or results of operations. The staff is also skeptical about the adequacy of the prior disclosure if a material charge is recorded related to an event that occurred several years before but the contingency was never disclosed. Disclosure should begin when a material loss becomes reasonably possible. The disclosures should discuss the nature of the contingency and the range of possible loss. Disclosures should not be vague or overly broad. Instead, they should provide specific information about the contingency.

### Uncertain Tax Benefits

There has been debate recently about accounting for uncertain tax benefits. Some believe that all tax benefits claimed on the tax return should be recognized, and then the loss contingency should be assessed following FASB Statement 5 and

accrued if it is probable. Others, including the SEC staff, believe it only is appropriate to initially recognize tax benefits when they meet the definition of an asset, i.e., it is probable (as defined in Statement 5) that the related deductions will be sustained under an IRS audit. This difference in views is illustrated using the example of a company that has claimed a deduction on its tax return that it believes has a 50% likelihood of being sustained. Under the first view stated above, the company would recognize the benefit of the deduction by reducing tax expense. Under the second view, the company would not recognize a tax benefit. In the first quarter of 2005, the FASB expects to issue a proposed interpretation of Statement 109, *Accounting for Income Taxes*, to address recognition, measurement, and classification of income tax benefits relating to uncertain tax positions. Until a final interpretation is issued, the staff expects companies to use a consistent and reasoned approach to the recognition of such benefits and to disclose their accounting policy when the policy could have a material effect on the financial statements.

The staff recognizes that some companies take positions on their tax return that do not meet the probable threshold. The staff believes that a current liability should be recorded for the difference, if any, between the benefit of tax deductions reflected on the income tax return and the tax benefit recognized under the company’s accounting policy. In addition, they believe companies should disclose both recorded and unrecorded exposures to contingent tax liabilities as required by Statement 5. The staff does not believe that the possibility of alerting the IRS or other tax

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authorities to uncertain deductions via these disclosures to be a valid reason for not complying with GAAP or SEC disclosure requirements.

### Transfers of Securities to and from the Trading Category

Although FASB Statement 115, *Accounting for Certain Investments in Debt and Equity Securities*, has been in effect for more than 10 years, the SEC staff continues to note inappropriate transfers of securities to and from the trading category. The staff believes that such transfers should be “rare,” although they concede that “rare” does not mean “never.” The staff does not consider the following reasons, often cited by registrants as the basis for such transfers, to be rare:

- Enacting a change in an investment strategy;
- Achieving accounting results more closely matching economic hedging activities; or
- Repositioning the portfolio due to anticipated changes in the economic outlook.

The staff, however, has cited examples of reasons for a transfer that they would consider acceptable:

- The adoption of a new accounting standard that explicitly permits a transfer;
- A change in statutory or regulatory requirements; or
- A significant business combination or other event that significantly alters an entity’s liquidity position or investing strategy.

The underlying premise is that circumstances giving rise to the transfer must be “unusual and highly unlikely to recur in the near term.”

### Other-Than-Temporary Impairments

In March 2004, the FASB’s Emerging Issues Task Force reached a consen-

sus on Issue 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, which provided guidance for disclosing, measuring, and recognizing other-than-temporary impairments. The model was controversial and the FASB decided to defer the effective date of the measurement and recognition provisions (but not the disclosure provisions) while it addressed concerns raised during the comment process. As a result, the SEC staff has reminded registrants to continue to follow Topic 5-M of the Staff Accounting Bulletins, *Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities*, as the basis for the impairment analyses for certain debt and equity securities, including those within the scope of FASB Statement 115. The staff expects registrants to employ a systematic methodology in preparing such analyses and to robustly document all factors considered, including those enumerated in SAB Topic 5-M.

The staff has also provided additional guidance for evaluating the impairment of available-for-sale securities. Under Statement 115 (paragraph 8), the sale of an underwater security that was previously classified as held-to-maturity may undermine a company’s stated intent to hold the security until maturity. The staff does not believe, however, that the concept of “tainting” should be applied to the available-for-sale *portfolio* if an underwater security is sold. While ability and intent to hold an underwater available-for-sale security for a sufficient time for it to recover its value is one of the factors that must be considered in evaluating whether it has been impaired, the staff believes the facts and circumstances surrounding individual (or larger groups of) sales

of securities should be evaluated to determine whether the hold to recovery assertion for the remaining securities classified as available for sale continues to be valid.

### Modification of Convertible Debt Instruments

In Issue 04-8, *The Effect of Contingently Convertible Instruments on Diluted Earnings per Share*, the EITF concluded that companies should include the dilutive effect of contingently convertible securities with a market price trigger in diluted earnings per share regardless of whether the market price trigger has been met. In response, some companies are modifying the terms of their debt agreements to mitigate the dilutive effect of these convertible instruments.

EITF Issue 96-19, *Debtor’s Accounting for a Modification or Exchange of Debt Instruments*, addresses circumstances under which certain debt modifications should be accounted for as extinguishments, resulting in gain or loss. The modifications are analyzed using a discounted cash flow analysis. According to the SEC staff, if a company modifies a conversion option to achieve a particular treatment under Issue 04-8, the change in the fair value of the option should be incorporated into the related analysis under Issue 96-19 to determine whether the modification results in a debt extinguishment. Accordingly, companies should compare the fair value (which includes time value and intrinsic value) of the option immediately before and after the modification. Any difference would be incorporated into the Issue 96-19 analysis as a current period cash flow, (i.e., a company would treat an increase in the value of the option to the holder as if it were a current period cash outflow).

### **Accounting for Employee Benefit Plans**

Although FASB Statements 87, 106, and 112 have been in effect for some time, the SEC staff has increased their focus on certain assumptions that are made in applying these pronouncements. They have emphasized the importance of using current and factually supportable assumptions. The staff continues to remind companies to regularly update assumptions related to factors such as retirement age, turnover, mortality, compensation increases, and discount rates in order to provide the appropriate measures of benefit obligations. The staff specifically cautions against using mortality tables that are out-dated or not reflective of the company's employee base. The staff also reminds companies that the selection of discount rate should be based on the estimated timing and amount of the company's benefit obligations. While the assumed rate of return on plan assets is not expected to change every year, it should reflect the company's planned investment allocation among asset classes and realistic long-term rates of return. Selecting discount and assumed asset return rates based on what similar companies are using is not a sufficiently rigorous approach.

The staff also reminds companies that they need to base their accounting on the "substantive" terms of benefit plans. The staff cites past practice, oral communications, and other contracts, such as collective bargaining agreements, as factors that affect what "employees have come to know as the plan" and need to be considered in identifying the substantive plan.

### **Changing Circumstances and Revenue Recognition**

The SEC staff has challenged registrants to continually assess whether changes in circumstances or contractual provisions related to their revenue transactions require them to change their accounting policies for recognizing revenue. For example, in the software industry, repeated software upgrades to existing products may change the conclusion that the related software is only incidental under Statement of Position 97-2. Companies should have procedures and controls in place to ensure that accounting policies evolve with the business model. This improves financial statement reliability and comparability for industries with complex revenue models, such as the technology sector.

### **Nonmonetary Exchanges**

Although APB Opinion 29, *Accounting for Nonmonetary Transactions*, requires nonmonetary transactions (with certain exceptions) to be measured at fair value, existing literature does not specifically address the timing and classification of nonmonetary transactions that culminate the earnings process. The SEC staff believes registrants should address these issues using the guidance provided in two FASB Concepts Statements and a Staff Accounting Bulletin. Such transactions should be recognized when the general criteria in Concepts Statement 5 and SAB Topic 13, *Revenue Recognition*, have been satisfied (i.e., revenue is recognized when it is earned and realizable, and delivery or performance has occurred). The related income statement classification depends on the nature of the transaction. Concepts Statement 6 provides that revenue classification is only appro-

priate if the inflow is derived from "activities that constitute...ongoing major or central operations." Otherwise, the transaction should be classified as a gain. A similar analysis should be performed to determine expense/ loss classification.

### **Fair Values and Useful Lives – Applying FASB Statements 141 and 142**

To estimate the fair value of intangible assets, FASB Statement 141, *Business Combinations*, requires a company to incorporate assumptions about duration of cash flows that a marketplace participant would use. In contrast, Statement 142, *Goodwill and Other Intangible Assets*, requires a company to estimate the useful life (i.e., the life over which the cost is amortized) of an intangible asset based on assumptions that are specific to the acquiring entity. The SEC staff accepts this conceptual difference and does not believe the life of an intangible asset should be limited for purposes of valuation pursuant to Statement 141 even if the useful life to be used for amortization purposes pursuant to Statement 142 is shorter.

### **Customer Acquisition and Related Costs**

The SEC staff continues to receive questions about whether customer and contract acquisition costs can be capitalized. While they believe it is almost always acceptable to expense such costs, the staff acknowledges it may be appropriate to capitalize customer or contract acquisition costs in certain instances. The staff points out, however, that no costs should be capitalized if capitalization is prohibited by existing GAAP (e.g., capitalization of internally generated intangibles) or capitalization is inconsistent with

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Concepts Statement 6, which states an asset must have future economic benefit. Further, costs may be capitalized only if they are direct and incremental to the contract, principles established in FASB Statement 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Lease*, and FASB Technical Bulletin 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*. The staff believes most capitalized acquisition costs are analogous to intangible assets, so registrants should follow the amortization and impairment guidance in FASB Statements 142 and 144.

### Consolidation of Variable Interest Entities

The SEC staff has addressed the following issues related to the application of FASB Interpretation 46(R), *Consolidation of Variable Interest Entities* (VIEs):

- “Activities Around an Entity” – Some registrants have asked whether certain “activities around an entity” would need to be considered in analyzing whether the entity is a VIE. For example, assume Investor A made an equity investment in a potential VIE and Investor A separately made a loan with full recourse to another variable interest holder (Investor B). Can the loan in this situation be ignored when analyzing the application of Interpretation of 46(R)? The staff believes the loan cannot be ignored. The loan should be considered in determining whether Investor B’s interest is at risk and whether the equity holders as a group have the characteristics of a controlling financial interest. According to the staff, other “activities around the entity” include but are not limited to equity

investments between investors, puts and calls between the enterprise and other investors and non-investors, service arrangements with investors and non-investors, derivatives (e.g., total-return swaps), and agreements among investors to make tax credits generated from an entity’s business available to one specific investor. The staff believes that all facts and circumstances should be considered in an analysis of Interpretation 46(R).

- Related Parties – Under Interpretation 46(R), if two or more related parties have variable interests that if held by a single party would identify that party as the primary beneficiary, then the party within the related party group that is most closely associated with the VIE is the primary beneficiary. Paragraph 17 lists four factors to consider in determining which member of a related party group is most closely associated with the VIE. The staff believes this list is not all-inclusive. In addition, they believe that no single factor carries more weight than any other factor. They remind registrants to consider all facts and circumstances that may be relevant in each situation.
- “Information-Out” Scope Exception – Under paragraph 4(g) of the Interpretation, a company may not have to analyze a potential VIE if, despite an exhaustive effort, it is unable to obtain the necessary information to do its analysis. This exception to the scope of the Interpretation applies only to entities created before December 31, 2003. For entities created after this date, a presumption exists that all information necessary to complete the analysis and, if necessary, to consolidate the VIE will be available. The staff has warned

that companies using the “information-out” scope exception should be prepared to support how they satisfied the exhaustive efforts requirement.

- Reconsideration Events – In order to maintain effective internal controls, the staff encourages registrants to establish controls and procedures to regularly obtain and review information from VIEs and other entities in which they hold variable interests and to identify and assess reconsideration events under paragraphs 7 and 15 of the Interpretation.

### Accelerated Vesting of Underwater Options

The SEC staff is aware that some companies, prior to adopting FASB Statement 123(R), *Share-Based Payment*, are considering accelerating the vesting of their “underwater options” (i.e., those options having an exercise price in excess of the current market price). This action would permit companies to avoid recognizing compensation expense in periods after adoption. The staff expects companies that modify their compensation arrangements prior to adopting the new standard to fully comply with the disclosure requirements Statement of 123. Under paragraph 47, a company must disclose the terms of significant modifications of outstanding awards for each year for which an income statement is presented. In addition, the staff expects companies to disclose the reasons for such modifications (e.g., to avoid compensation charges). In their opinion, disclosures such as, “During fiscal 2004 certain of the company’s stock options were modified to accelerate vesting,” would not be sufficient.

### Valuation of Privately Held Company Equity Securities (“Cheap Stock”)

One of the more frequently targeted areas of SEC staff review in initial public offerings is the valuation of stock or stock-based awards. The staff routinely questions whether a registrant should have recorded compensation expense with respect to stock options, restricted stock and other equity-based awards granted to employees, directors and consultants during the 12 months prior to the offering. Generally accepted accounting principles require a company to record compensation expense for any option granted to employees with an exercise price, or any stock sold with a purchase price, below the “fair market value” of the underlying stock on the grant date (cheap stock). A company should be prepared to justify its determination of the common stock’s fair market value as of each grant date, an arduous task when no quoted market price exists. The AICPA recently issued an Audit and Accounting Practice Aid, *Valuation of Privately-Held-Company Equity Securities Issued as Compensation*, which the staff believes provides useful guidance.

Generally, companies use a two-step approach. In step one, they calculate the total value of the enterprise. In step two, they allocate that value to the various classes of securities (if there are multiple classes of equity). The staff regularly

identifies shortcomings in three areas:

- **Appropriate valuation model** – The valuation model selected should take into consideration the company’s current stage of development. In the staff’s opinion, an asset-based approach is probably not appropriate except in the earliest stages of development. In most IPOs, a market or income approach would be more appropriate.
- **Allocation of enterprise value** – If there is more than one class of equity securities, the total enterprise value will need to be allocated among the classes. The staff believes the current value method generally is not appropriate unless a liquidity event is imminent. Acceptable approaches would include the probability-weighted expected return method and the option pricing method. The staff believes registrants should select the method that is most appropriate for their circumstances and use that method. The staff believes it is not meaningful to calculate value using more than one method and then average the calculated values.
- **Applying valuation discounts** – Lack of control discounts can be justified only if a company can demonstrate that the controlling shareholder will receive higher returns, which is generally not the case. Lack of marketability dis-

counts need to be supported by company-specific, objective information. General experience of the valuation professional with discounts applied by other companies is not sufficient. Generally, the longer the restriction period and the greater the volatility of the value of a security, the higher the discount should be.

Privately-held companies contemplating IPOs should give careful consideration to these issues and develop specific, contemporaneous documentation to support key assumptions and methodologies, as these will likely be subject to staff scrutiny during the review process.

### For Further Information

If you would like further information or to discuss the implications of these matters, please contact the BDO Seidman, LLP engagement partner serving you or one of the following partners:

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