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Accountants and Consultants



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Report on AICPA SEC Conference

The annual AICPA National Conference on Current SEC Developments, held on December 4-6, 2000 in Washington, D.C., provided insights into the SEC staff's views on various accounting and reporting issues. The remarks made by the Chief Accountant 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 "SEC Digest & Statements, Speeches by SEC Officials." The remarks made by members of the Division of Corporation Finance at the conference are not publicly available. The SEC staff and commissioners have also made various other speeches throughout the year, which are also available on the SEC's Web site. Insights from some of those speeches are also included.

Summary

For the last two years, the SEC focused on the erosion of quality financial reporting through "earnings

management," as its highest priority. Now, the emphasis appears to be focusing on "back to the basics" types of issues such as revenue recognition and adequate disclosures.

Revenue recognition will continue to be an area of focus into 2001. Revenue is the line item most often misstated in financial fraud cases. Because implementation of Staff Accounting Bulletin 101, *Revenue Recognition* (SAB 101), is required in the fourth quarter of 2000 for calendar-year companies, the SEC will be reviewing the impact of its adoption in year-end filings. To date, very few companies have disclosed that they expect to make changes in their accounting policies for revenue recognition due to the adoption of this SAB.

Focus is also expected to center on the adequacy of disclosures in MD&A regarding revenue recognition, segment reporting and improved discussion of cash flow information. Registrants need to pay particular attention

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to the consistency of MD&A disclosures with other information provided in press releases; on the registrant's Web site; provided to analysts; provided in the annual report, including the president's letter; and in the financial statements.

Revenue Recognition

After issuance of SAB 101 and its related Q&A (See *SEC Year in Review: Significant 2000 Developments*), the SEC staff has continued to answer questions related to revenue recognition. One important question involves the requirement in Statement of Financial Accounting Standards (SFAS) 48, *Revenue Recognition When Right of Return Exists*, that in order to recognize revenue at the time of the sale, companies are able to reasonably estimate the amount of returns. To be able to reasonably estimate the amount of returns, generally a registrant must have an operating history. The question is "what constitutes adequate history in order to estimate returns?" The SEC staff indicated there is no bright line specifying a particular time period before estimates can be made. The following questions should be considered when determining if the amount of returns can be reasonably estimated:

- Are the sales being made under a new business model which has not been used by the company before?
- Are the sales made using different distribution channels than previously used?
- If a new product, is the product similar to a product that has been sold in the past?
- If the company sells a wide range of products, is the return rate based on the specific product line and not an overall rate?

The SEC staff has stated that the estimate of returns must be made at the time of the sale, not

subsequent to the date of the sale. Where returns cannot be estimated at the time of the sale, revenue should not be recognized until the period in which the return privilege expires, even if the return period expires before the financial statements are issued.

Another question addressed the requirement for the revenue to be "fixed and determinable" prior to recognition in the financial statements. The example provided was a company that earned revenue based on a percentage of tax assessment savings for two years. The staff believes that the revenue related to the tax savings was not fixed and determinable and revenue could not be recognized until the tax bill was received and the actual amount of the savings could be determined. Even though the amount could reasonably be estimated, the amount was based on future events and, therefore, was not fixed and determinable.

Lastly, on the topic of revenue recognition, there was a discussion on a basic revenue recognition issue – the impact of shipping terms on the timing of revenue recognition. If goods are shipped F.O.B. destination, then title does not transfer until the goods reach their destination. Revenue cannot be recognized in normal circumstances until title has passed to the buyer.

Segment Reporting

The SEC staff continues to remind registrants that they are carefully reviewing segment disclosures. They generally believe that the implementation of SFAS 131, *Disclosures About Segments of an Enterprise and Related Information*, has not substantially improved disclosures related to segments. When the staff reviews a filing, they will also review the company's other

publicly available information for consistency with its reported segments. If the annual report, Web site, information discussed with analysts, etc. implies the existence of additional segments, the staff will look for additional disclosure in the financial statements. Where segments do not currently meet the quantitative disclosure thresholds, but other information indicates that such segments may be significant in the near future, registrants should consider whether information related to these segments is essential to understanding its business.

The SEC staff has frequently asked to see information provided to the chief operating decision maker. If they determine that additional segments should be disclosed, they will generally require the financial statements to be restated, rather than corrected in future filings. Additionally, registrants may also be required to amend their MD&A to include additional disclosures related to their segments. A registrant that aggregates its operating segments into reporting segments should disclose the basis used for aggregation.

Other Than Temporary Declines in Market Value

For available-for-sale equity investments under SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*, "If the decline in fair value is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value and the amount of the write-down shall be included in earnings."

During the past few years, the overall stock market has posted impressive gains, and issues related to declines in market values have not been relevant to a broad base of stocks. In 2000, the stock

market, particularly the NASDAQ market, experienced significant declines without offsetting increases in value. This market condition focuses sharply on the need to evaluate securities on a periodic basis for other than temporary declines in value.

Management needs to assess the available information, including the current market price, to determine if the investment is impaired. Management will also need to document the factors considered in reaching its conclusions. The SEC staff has previously provided guidance in this area through the issuance of SAB 59, *Accounting for Noncurrent Marketable Equity Securities*. In that guidance, the staff indicated that “other than temporary” does not mean permanent. Management, therefore, may have an obligation to write down the carrying value of a security that has a decline in value prior to the point at which it judges an impairment to be permanent. SAB 59 states that registrants should consider factors such as the length of time and the extent to which the market value has been less than the cost, the financial condition and near-term prospects of the issuer, and the intent and ability of the registrant to retain its investment to allow for the market to recover. These considerations, as well as other relevant factors, should be documented to support the conclusion regarding the valuation of the investment.

Likewise, management should also evaluate for potential impairment any investments that do not qualify for treatment under SFAS 115 (i.e., restricted securities or those for which a traded market is not available). Any impairment determined to be necessary should be recorded through the current period’s income statement. If the decline has previously been recorded as an unrealized loss, the amount of the impairment should

be treated as a realized investment loss and should be reclassified from equity to the income statement.

Redemption Terms In Preferred Stock Arrangements Which Would Require Classification as Temporary Equity

Many preferred stock agreements contain provisions that may require a company to redeem the stock. In some cases, these provisions may be beyond the control of the company. Rule 5-02 of Regulation S-X requires registrants to classify outside of permanent equity all securities that are redeemable on the occurrence of an event that is outside of the control of the issuer. Specific areas where the provisions are beyond the control of the company include:

- Death or retirement of the holder
- Change in control of the company
- Violation of certain covenants
- Requirement to maintain a specific stock price or attain a specific earnings level
- Redemption of the preferred stock requiring the issuance of more shares than are currently available; shareholder approval is required to authorize additional shares and redemption in cash would be required if shares are not available
- NASDAQ or other exchange requirement for shareholder approval prior to the issuance of the common shares, and redemption in cash would be required if shares are not available

Additionally, the probability of a triggering event should not be considered in determining the classification of the instrument. These rules should be applied to all types

of equity (i.e., options, warrants, etc.), not just preferred stock. Therefore, any documents relating to preferred stock and other equity issuances must be carefully reviewed for the existence of any redemption features that may be outside of the registrant’s control.

Questions Related to Timely Quarterly Reviews

During 2000, the SEC’s new rules became effective requiring a registrant to obtain a timely quarterly review of its financial statements prior to filing its 10-Q or 10-QSB. Subsequent to the effective date of the new requirement, registrants and auditors have raised implementation questions. The SEC staff recently addressed several of those questions. The most significant issue was related to Section 10A requirements.

Section 10A requires auditors to bring illegal acts to the attention of senior management and the registrant’s audit committee. If no corrective action is taken, the auditor must report the act to the SEC. If, upon discovery, the auditor resigns, that does not relieve him/her from the reporting responsibility. The SEC staff concluded that failure to have an auditor review the quarterly information on a timely basis constituted an illegal act that would fall under the disclosure requirements of Section 10A. If the registrant disclosed in its filing that the quarterly financial statements had not been reviewed, then adequate disclosure has been made and the auditor would not have any further reporting requirements under Section 10A.

Failure to make a timely quarterly filing, including completion of the auditor’s review, would mean the registrant was not a “timely”

filer. Registrants must have the review completed and wait one year from the date the untimely filing has been corrected to be eligible to utilize Forms S-3 and S-2, which allow the registrant to incorporate certain information by reference.

Accounting Changes

Under Accounting Principles Board Opinion 20, *Accounting Changes* (APB 20), a change in accounting principles usually is recorded as of the beginning of the year as a separate line item in the income statement. The adjustment reflects the cumulative effect of the change on beginning retained earnings. Only in specific circumstances would a change be recorded retroactively. Paragraph 29 of APB 20 discusses one such special exemption for recording accounting changes for an initial public distribution of financial statements. APB 20 indicates that in this circumstance, changes in accounting principles may be recorded retroactively. The SEC believes that new investors would find financial statements consistently presented on the new basis (that is expected to be used going forward) more meaningful than on the old basis.

The SEC staff has concluded that this exception should be narrowly applied, and that it does not apply to subsidiaries of public companies. The exception is only available to companies whose securities are not widely held prior to their initial public distribution. A subsidiary of a public company is considered widely held if the parent company's stock is widely held. When the exception is met, the auditor's opinion should include an additional explanatory paragraph highlighting the change.

The SEC staff has indicated that the exception in paragraph 29 may not be used in situations that are

corrections of an error, which should be recorded as a prior period adjustment. A correction of an error must include the disclosures in paragraph 37 of APB 20 (i.e., the nature of the error and the effect of the correction on net income and earnings per share). Additionally, the auditor's report should indicate there was a change for a correction of an error.

Changes in estimates also require disclosure in the financial statements in accordance with APB 20 and in MD&A. Changing certain estimates could be perceived to be linked to earnings management. Therefore, any such changes should be fully discussed, including the basis for the change and the current and expected future impact on the financial statements.

SEC Enforcement Issues

Combating fraud remains the number one priority of the SEC Division of Enforcement. Richard Walker, Director of the Division, noted that the "numbers game" is getting progressively harder to "win." In May of 2000, the SEC formed a Financial Fraud Task Force comprised of a team of accountants and lawyers which focuses exclusively on financial reporting and accounting investigations. During 2000, the Division initiated over 100 financial reporting cases, a 10% increase over the prior year. Today's emphasis is focusing on naming individuals as well as companies. Fifty percent of these cases involved revenue recognition. Issues included: improper use of bill-and-hold; fictitious sales; revenue recognition before risks and rewards of ownership have passed to the buyer; shipment of unrecorded goods; and shipment to off-site warehouses. Other enforcement actions deal with: inadequate reserves for losses

on accounts receivable, loans or returns; improper deferral of expenses; failure to accrue liabilities and improper use of reserves; and MD&A deficiencies.

International Reporting Issues

Rule changes to Form 20-F became effective for registration statements filed on or after September 30, 2000 and for annual reports filed for years ending on or after September 30, 2000. The rule changes primarily affect non-financial statement disclosures and bring the SEC's disclosure requirements in line with the international disclosure standards endorsed by the International Organization of Securities Commissions. The new rules revised the definition of "foreign private issuer" to clarify that foreign companies should determine whether their shareholders are U.S. residents based on a beneficial ownership test rather than a record ownership test. Additionally, the new rules require that the audits of foreign private issuers be performed in accordance with U.S. generally accepted auditing standards (GAAS) and that the audit reports specifically make reference to U.S. GAAS. The past practice of stating that the audits were conducted in conformity with home-country GAAS which is "substantially similar" to U.S. GAAS is no longer acceptable.

During the year, the SEC staff developed a new publication called *International Financial Reporting and Disclosure Issues in the Division of Corporation Finance*. The publication discusses current developments and includes significant staff interpretations and practices affecting foreign registrants that were previously not available. It is available on the SEC's Web site, www.sec.gov, and will be updated periodically to

reflect new issues and rule-making developments.

Statutes or regulations in various countries require that an accountant's report be obtained in stock-for-stock mergers or other non-monetary exchange transactions. The report addresses the consideration to be exchanged, and the auditor provides assurance as to the objectivity of the valuation procedures and results by either agreeing or disagreeing with the selected exchange ratio. If an auditor renders an opinion on the value of a company, the adequacy of the consideration or the fairness of a transaction that the auditor will subsequently audit (fairness opinion), either voluntarily or through a requirement of law, the SEC staff considers the auditor's independence to be impaired. The SEC does not accept compliance with foreign independence rules as a substitute for SEC independence rules and regulations. The only remedy in such situations is to engage another auditor to reaudit the historical financial statements for the periods for which it is determined that the auditor is not independent.

Other Issues

Other SEC staff views that may impact registrants in future filings include:

- Registrants should not record liabilities acquired in a business combination at an amount materially different from the amounts at which they were recorded in the target's historical financial statements. An exception to this guidance occurs when the registrant expects to settle the liability in a substantially different manner than the target. Additionally, the SEC staff has said the registrant has the responsibility to determine that the historical financial statements of the target, filed by the registrant, are in compliance with Regulation S-X Rule 3-05.
- The SEC staff expects to review more periodic filings in the current year as the volume of initial registration statements has declined.
- Income statement captions should be clearly representative of the composition of the amounts in that line item. For example, the caption "Merger and other costs" should be primarily merger costs, not other costs.
- The form in which consideration is paid (e.g., stock or cash for consultants' fees, salaries or bonuses, etc.) should not affect the income statement classification of the consideration. The SEC staff indicated they generally would not object if non-cash amounts were shown parenthetically after the related income statement line item (e.g., cost of sales, including non-cash compensation of \$20,000) or as a separate line item in the same category (cost of sales – non-cash compensation). The amount of the non-cash consideration should be shown in the cash flow statement.
- Registrants should ensure the completeness of income statement line items. For example, does cost of sales include all inventory costs, such as freight-in, purchasing and receiving costs, internal transfer costs, etc.?
- A change in senior management is not one of the triggering events for evaluating impairments under SFAS 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed of*. The SEC staff indicated they have seen an increasing number of impairment charges seemingly triggered by changes in management. The analysis should be based on changes in the business and economics which caused the impairment and should consider if those changes were adequately disclosed in MD&A.

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



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