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In 2003, the Securities and Exchange Commission issued many new rules. Most of the SEC's rules addressed specific provisions in the Sarbanes-Oxley Act of 2002, which required SEC rulemaking by specific dates. Additionally, the Financial Accounting Standards Board and the Emerging Issues Task Force issued a number of significant new accounting standards and interpretations. Many of these statements and interpretations were in response to the widely publicized accounting scandals in 2002. Some of these issues had been discussed for many years, but became much more critical because they related to areas in which fraud had been alleged. Many questions and issues have arisen in applying these new rules and interpretations. The SEC staff, through consultations with registrants and filing reviews, has communicated its views regarding the application of some of the rules. Additionally, at the annual AICPA National Conference on Current Developments, held on December 10-12, 2003 in Washington, D.C., the staff provided or reiterated their views on various accounting and reporting issues. The purpose of this letter is to provide you with insight into the staff's views on several important matters. The letter covers these matters in three sections:

- Accounting issues,
- SEC reporting issues and
- International reporting issues

Accounting Issues

Revenue Recognition

In late 2002, after almost three years of contentious debate, the EITF came to consensus on EITF Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*, effective for arrangements entered into, or significantly modified, in periods beginning after June 15, 2003. The consensus provides guidance on the separation and allocation of fees for revenue arrangements that include multiple deliverables. Numerous questions have arisen since the issuance of this consensus, including its applicability to certain industries or transactions; and the application of certain provisions, most notably those involving contingent revenue. The staff's interpretations of EITF 00-21, as well as some other general revenue recognition matters, are described below.

Applicability to software arrangements

Although EITF 00-21 provides criteria for the allocation of arrangement fees, it does not apply to multiple deliverables whose allocations are already addressed in higher level GAAP. For example, software companies often enter into arrangements that include build-to-suit software design and installation, as well as ongoing services (e.g., post contract support) under a long-term contract. Historically, as required by AICPA Statement of Position (SOP) 97-2, *Software Revenue Recognition*, software companies that entered into such bundled arrangements involving significant customization, accounted for such arrangements in their entirety under SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*. However, SOP 81-1 only addresses arrangements that include con-

struction and related services; not non-construction related services, such as post contract support. As such, the staff believes that software companies that provide bundled arrangements must apply the criteria in EITF 00-21 to separate SOP 81-1 deliverables (construction related) from non-SOP 81-1 deliverables (non-construction related).

Contingent revenue

Under EITF 00-21, fees allocated to a delivered item are limited to the amount that is not contingent on the delivery of additional items or specified performance conditions. As a result, there may be situations where, although the separation criteria have been met, the revenue allocated to the delivered item may be less than the associated costs. For example, a registrant may sell equipment and installation on a bundled basis with a portion of the payment relating to the equipment due upon completion of the installation. Under EITF 00-21, the deferred payment, which would be considered contingent revenue, would not be allocated to the delivered equipment and could result in loss on the sale of the equipment with significant profits on the installation. In such a situation, the staff would object if a registrant, in an attempt to avoid an upfront loss, chose not to separate the deliverables. The staff has stressed that separation is not an "election" under EITF 00-21, as had been the case under SEC Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements*. As such, a registrant may no longer elect to defer revenue on the entire arrangement until installation is complete.

Cost of revenue transactions

In light of this contingent revenue issue, the staff has been focusing on the accounting for direct costs

incurred in a revenue arrangement in which little or no revenue is allocated to a delivered item. GAAP does not currently address the capitalization of such "fulfillment" type costs and the EITF consciously chose not to address the issue – viewing it as too broad. Historically, the staff has not objected to the capitalization of direct costs provided they did not exceed deferred revenues or were otherwise supported by a contractual arrangement. Such an approach, if applied to contingent revenue situations, would generally not result in cost deferrals since contingent revenue is associated with the future deliverables and does not represent deferred revenue on the delivered item.

As a result, the staff believes that the accounting for such costs should focus on whether or not assets have been generated. The staff has provided the following examples of circumstances in which asset recognition may be appropriate:

- In-substance consignment sales – If the vendor does not have the right to bill for a delivered product, then a question could be raised as to whether the risks and rewards of ownership have been transferred to the customer. If the transaction is in substance a consignment sale, the costs would be capitalized under Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*, as consignment inventory.
- Contractually guaranteed reimbursable costs – Under EITF 99-5, *Accounting for Pre-Production Costs Related to Long-Term Supply Arrangements*, certain costs may be capitalized, if they will be contractually reimbursed by the customer. Analogy to this capitalization model may be appropriate in certain circumstances.

- Investment in a contract – If the revenue allocated to the remaining deliverables exceeds their fair value, the loss on delivered items may be an investment in the remainder of the contract. In such situations, the staff would expect continuous testing for future impairment based on the expected cash flows relating to the remaining services to be performed under the contract.

However, the staff has cautioned that recognition of an asset in a multiple deliverable arrangement would only be appropriate in those situations where the contingent revenue provisions of EITF 00-21 result in a loss on the delivered item. Deferral of costs to achieve “normal” margins for a delivered item would not be appropriate.

The staff has also acknowledged that recognition of an asset itself would raise additional questions such as the nature of the costs used in calculating the loss on the delivered item, the life of the asset and the amortization method, and the assessment for impairment. They also could include the broader question as to whether any loss should be recognized upon execution of a contract when the overall arrangement is expected to be profitable. Overall, the staff does not believe a “one size fits all” model is appropriate or feasible when analyzing and accounting for direct costs incurred in such situations. As a result, the staff will continue to address cost deferral issues on a facts and circumstances basis.

Separation criteria

Under EITF 00-21, separation of an arrangement into multiple deliverables is required for arrangements that meet certain specified criteria. Specifically, to qualify for separation the delivered item must have a “stand-alone value”. Although this

value does not have to be the value for an identical item, it should be the value for an item that, at a minimum, is interchangeable, with the delivered item. The staff has indicated that it will challenge any value that is based solely on scrap value.

Similarly, if a general right of return exists relating to the delivered item, the arrangement may only be separated if the delivery of the undelivered item is probable and within the control of the vendor. The staff has clarified that in their view this criterion is concerned with specific rights of return based on a vendor’s failure to perform; not with general rights of returns addressed in Statement of Financial Accounting Standards (FAS) 48, *Revenue Recognition when Right of Return Exists*.

Long-term service contracts

Previously, the staff has noted that many registrants had inappropriately applied SOP 81-1 to long-term service contracts. The staff has indicated that long-term service contracts, other than those specifically identified in the SOP (e.g., engineering, architecture), were outside the scope of SOP 81-1 and that SOP 81-1 should not be applied by analogy when accounting for service contracts. The staff has stated that alternative accounting methods for such service contracts may include straight-line, proportional performance, and completed contract. But if a proportional performance approach were to be used, the staff has reaffirmed that for contracts outside the scope of SOP 81-1, a cost-to-cost approach (based on input measures) rarely provides a good estimate of proportional performance and is generally not appropriate for revenue recognition purposes.

However, the staff generally would not object to a proportional

performance method based on output measures (such as milestones) as contemplated under SAB 101. Additionally, the staff would not object to recognition based on input measures (such as hours), if such measures are a reasonable surrogate for output measures. For example, in a typical time and materials type contract (with no interim deliverables or milestones), a customer may receive the benefit of, and be obligated to pay for, the services as performed. In such a situation, the staff believes that revenue recognition based on hours worked would be consistent with the proportional revenue recognition concepts in SAB 101. The staff stressed that the key focus in assessing revenue recognition should be the rights and obligations of the customer and the service provider. Provided all other revenue recognition criteria have been met, the revenue recognition method selected should reflect the pattern in which the obligation to the customer is fulfilled.

Software arrangements involving hosting

Some software that involves significant customization is provided solely through hosting services. In other cases, hosting may be offered as an alternative to the license or sale of the underlying software. The EITF, through issuance of its consensus on Issues 00-3 and 03-5, has identified, in general terms, the accounting principles (dealing with both revenue recognition and the capitalization/expense of development costs) that should govern hosting arrangements. For example, in certain situations where software is only provided through a hosting arrangement, EITF 00-3 states that the revenue should be recognized over the service period (not under SOP 97-2) and that similarly, the development costs

should be accounted for under SOP 98-1 (not under FAS 86).

As a result of these positions, situations could exist where hosting arrangements are not covered by SOP 81-1 (scoped out of SOP 97-2) and do not meet the separation criteria in EITF 00-21. In such situations, the staff indicated that it may be appropriate to recognize revenue only upon delivery of the last delivered item or perhaps under a proportional performance model. Regardless of the model chosen, the staff will challenge any accounting policy that would result in revenue recognition upon delivery of the element that could not be separated, since such a policy would be contrary to EITF 00-21. Additionally, even in situations where SOP 97-2 is applicable (e.g., a software provider that both sells and hosts software), the staff believes that the revenue should be recognized over the hosting period, with no revenue attributable to the customization, since most of the payments would be tied to the hosting arrangement.

SAB 104 update of SAB 101

In 2001, the staff issued SAB 101, to provide interpretive guidance for situations not addressed in the accounting literature. As a result of the issuance of EITF 00-21, the staff updated this guidance in December of 2003 through the issuance of SAB 104. The objective of the SAB 104 was to eliminate guidance on matters that are now addressed by GAAP (e.g., multiple element arrangements), not to reinterpret SAB 101 in light of such GAAP. As a result, some staff positions that conflicted with current GAAP or were redundant were eliminated or restricted in terms of their applicability. Significant revisions included the following:

- The accommodation allowing deferral of revenue recognition

on equipment until completion of installation was eliminated.

- The requirement to defer revenue recognition if the undelivered item is “essential to the functionality” of the delivered item was retained, but is applicable only to single units of accounting (e.g., those elements not meeting the separation criteria under EITF 00-21).
- Similarly, the ability to accrue costs and recognize revenue if future services are “inconsequential or perfunctory” has been retained but only for revenue recognition on single units of accounting.

SAB 104 retained the definitions of deliverables (e.g., cellular activation is not a deliverable because it provides no additional benefit to the customer).

Business Combinations

In June 2001, the FASB issued FAS 141, *Business Combinations* and FAS 142, *Goodwill and Other Intangible Assets*. The staff has addressed a number of issues that have arisen since adoption of these standards, as well as some general business combination issues.

Contingent consideration that may be compensatory

When a business combination involves contingent consideration, the registrant needs to determine whether such consideration is additional purchase price or a period expense. From a conceptual standpoint, contingent consideration that resolves differences between the buyer and seller regarding the value of the business should be additional purchase price. However, when a shareholder becomes an employee of the acquirer, it is often difficult to determine if the consideration is for post-combination services or for resolution of purchase price.

EITF Issue No. 95-8, *Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination*, provides a number of factors to consider when making this determination (e.g., continuing employment, reasons for contingent payments, and formula for determining consideration). Although various factors are addressed, contingent payments that are automatically forfeited upon termination are cited as a “strong” indicator that the consideration is compensation for post-combination services.

The staff reaffirmed that when continuing employment is required, it would be very difficult to overcome the presumption that the arrangement is compensatory. However, the staff indicated that this presumption is not a bright line test and that in rare situations, despite a continuing employment requirement, they have concluded that contingent consideration should be treated as additional purchase price. In reaching such conclusions, the staff considered the following:

- Are other selling shareholders, who are not employees of the acquirer, entitled to the identical contingent consideration on a per share basis? If so, why are the continuing employees subject to an employment contingency?
- Is the employee’s compensation, including the contingent payments, significantly greater than what he would be expected to earn as an employee?
- Is the formula used for determining the contingent consideration consistent with the model used when initially valuating the business (e.g., high end of a valuation range)? And if so, why was an employment contingency required?
- And most importantly, why was the contingent consideration

included in the arrangement in the first place? In essence, if the basis of the contingency is to keep the individual working for the company, the staff believes there is no basis for treating it as anything other than compensatory.

Customer related intangible assets

Since the issuance of FAS 141 and 142, many issues regarding customer related intangible assets have arisen (e.g., recognition, life and valuation). EITF 02-17, *Recognition of Customer Relationship Intangible Assets Acquired in a Business Combination*, clarified that contractual rights exist, regardless of whether or not a contract exists at acquisition date, if an entity has a practice of establishing contracts with its customers. Those contractual rights would then need to be valued as a separate intangible asset. Expanding upon this consensus, the staff indicated that customer related intangible assets may exist in a wide variety of situations and advised registrants to have a broad focus when analyzing what is acquired in a business combination. For example, in an acquisition of income producing real estate, the staff believes that a company may not simply be acquiring fixed assets and underlying leases, but a customer related intangible asset based on a lessor/lessee contractual relationship as well. Such an intangible asset may reflect the acquirer's ability to lease additional space to the tenants, the value of the tenants as a referral source, or the probability that the tenants will sign new leases when their current leases expire.

Additionally, the staff has stated that such an asset would generally be treated as a finite-lived intangible asset. In the staff's view, a customer related intangible

asset is based on relationships with customers as well as with individuals in the customer's organizations, both of which are subject to turnover. Additionally, economic conditions, such as competition and demand, and a customer's ability to transfer business with minimal cost or penalty, would be indicators of a finite life. Consequently, the staff believes treatment of a customer related intangible asset as an indefinite lived asset would be extremely rare.

The staff also clarified that the fair value of such intangible assets should be based on a marketplace participant view, rather than entity specific assumptions. For example, in the acquisition of income producing real estate, a valuation based merely on costs incurred to "establish" a relationship or "sign-up" a tenant, would generally be inappropriate and inconsistent with the FAS 142 definition of fair value. Rather, an appropriate valuation would consider, among other things, the volume of business that the tenant may generate, other aspects of the relationship (e.g., referral capability), or other factors that would be considered by a marketplace participant when assessing the asset value.

Amortization methods for finite-lived intangible assets

Prior to the adoption of FAS 142, registrants had historically amortized intangible assets on a straight-line basis over an estimated or contractual life. But consistent with FAS 142, the amortization method should reflect "the pattern in which the economic benefits ... are consumed or otherwise used up." Only in situations where such patterns cannot be reliably determined, is the straight-line method appropriate. When analyzing the patterns of consumption, the staff believes registrants should focus on pro-

duction or output. For example, if an intangible asset contains no limitations on output, amortization over the life on a straight-line basis may be appropriate. Conversely, straight-line amortization may not be appropriate for an intangible asset that limits production to a finite quantity. The staff cautioned that non straight-line amortization methods must clearly meet the criteria of reliably determinable and be based on supportable assumptions.

The staff also discussed situations in which the full value and benefits of an intangible asset, already in service, will not be realized until the completion of construction of certain related tangible assets. In such a situation, the staff would reject any approach that would "phase in" amortization expense as the related tangible asset was constructed. In the view of the staff, even though the intangible asset would not be utilized at "full" capacity, the company would still be deriving benefits from the intangible asset. Such an approach is consistent with the concepts in EITF Topic D-21, *Phase -In Plans When Two Plants Are Completed at Different Times but Share Common Facilities*, as applied to physical tangible assets.

Identification and valuation of intangible assets

Under FAS 141, the purchase price allocation requires a company to make a rigorous effort to identify all intangible assets. In the staff's view, intangible assets would include mineral rights, since FAS 142 specifically identifies them as such. This view represents a significant change from current industry practice, in which such rights are reflected as tangible assets. The EITF has agreed to address this classification issue, as well as a number of other issues specific to the mining industry. Nevertheless,

until a consensus has been reached by the EITF and confirmed by the FASB, through amendments to FAS 142, the SEC will view mineral rights as intangible assets. The staff believes this same issue and conclusion applies to oil and gas companies. Although the accounting for such rights is scoped out of FAS 142 (since it is addressed in FAS 19, *Financial Accounting and Reporting for Oil and Gas Producing Entities*), the staff believes that the classification of such rights is subject to FAS 142.

In a purchase price allocation, any excess of cost over fair value of assets acquired and liabilities assumed, should result in only one residual intangible asset. Although this residual asset is generally goodwill, the staff stated that there might be limited circumstances in which the residual value may be assigned to an identified intangible asset. But the staff cautioned that such a situation would raise additional questions regarding impairment assessment (e.g., method to be used, cash flows to be considered). At a minimum, the staff believes that an impairment assessment would need to consider unrecognized intangible assets when determining an implied fair value (similar to the test that would be required for goodwill). Additionally, the staff has indicated that the value assigned to the residual asset should also include the related deferred income tax liability. A registrant assigning residual value to an identified intangible asset should expect comments and/or challenges by the staff.

Settlement of litigation regarding purchase price

The staff has clarified that contingencies arising from a business combination, such as legal claims between an acquirer and the former owners of an acquired busi-

ness, are not preacquisition contingencies under FAS 141. As such, the resolution of such contingencies would ordinarily be reflected in the income statement and not as an adjustment to the purchase price. However, in certain instances where the registrant has demonstrated a clear and direct link between the litigation settlement and the purchase price, the staff has agreed to recognition as a purchase price adjustment. For example, a litigation settlement may relate to enforcement of an escrow or escrow-like arrangement covering minimum levels of acquiree working capital. Or it may relate to a misrepresentation claim wherein the seller represented that 1000 customers, each worth \$1000, would be transferred, and only 900 actually were. However, the staff has cautioned that even in situations where there is a clear and direct link, treatment as a purchase price adjustment would only be appropriate if the litigation settlement confirmed that the fair value initially allocated to that item was incorrect.

Conversely, claims that are not unique to business combination (e.g., claims that one party misled another or that a provision in the agreement was unclear) would not generally establish a clear and direct link to the purchase price, and would be reflected in the income statement. For example, if a seller agreed to use its “best efforts” to retain customers through consummation date, a litigation settlement as a result of a seller’s failure to do so would provide no clear and direct link and would be an adjustment to the income statement.

Additionally, in those situations where purchase price adjustment is appropriate, the adjustment should be reflected and accounted for in a manner consistent with the original purchase price allocation

and subsequent reporting. In other words, if a litigation settlement related to an asset that was written-off subsequent to the acquisition (e.g., minimum net realizable value for acquired accounts receivable was not met) the purchase price adjustment should similarly be recognized in the income statement of the current period.

Regardless of the above discussion, any litigation brought by the acquirer’s shareholders would always be reflected in the income statement.

Accounting for Derivative Instruments

Income statement classification and disclosure under FAS 133

The staff discussed the income statement presentation of gains and losses on derivatives used as economic hedges but not designated as accounting hedges. The staff will object to the presentation of unrealized gains and losses in one income statement caption (e.g., risk management activities) with reclassification of realized gains and losses (upon periodic or final cash settlement) into a different revenue and expense caption associated with the related exposure. Although FAS 133, *Accounting for Derivative Instruments and Hedging Activities* is essentially silent on geography, the staff has noted that this presentation is similar to synthetic accounting which was eliminated by FAS 133. The staff has asked registrants to report all gains and losses for economic hedges on one caption in future filings.

While the staff has not answered the question of where the gains and losses could or should be classified, the staff has noted that some classifications may not make sense (e.g., a financial institution classifying all changes in credit derivatives used as eco-

conomic hedges in the provision for loan losses, given the significance of that caption to credit quality analyses). Registrants are encouraged to disclose the amount of the gains and losses on economic hedges, as well as the location in the income statement. The staff also reminded registrants to clearly discuss, in Management's Discussion and Analysis (MD&A), the reasons for entering into economic hedges and to focus on the clarity of disclosure when the registrant uses both hedges that qualify for hedge accounting and economic hedges, that do not qualify for hedge accounting.

Hedge documentation and designation

Under FAS 133 hedge accounting can be achieved only if stringent documentation and effectiveness requirements are met. The staff recently has noted situations of "sloppy" documentation and aggressive interpretations of the guidance related to effectiveness testing. FAS 133 requires that at inception of the hedging relationship, an entity must define and document the method it will use to assess the hedge's effectiveness. The staff has noted instances where registrants initially document a series of different effectiveness tests (e.g., dollar-offset assessments and/or other statistical analyses using different hedge periods) and conclude that the effectiveness testing requirements of FAS 133 have been met if any one of these methods shows the hedge is highly effective. The staff believes that this position is not consistent with the criteria in FAS 133 since more than one method was used to assess effectiveness. The staff also noted it would object to situations where the designated hedge period is different from the period over which the hedged portfolio is rebalanced.

Finally, the staff has noted several instances where registrants used statistical techniques to assess hedge effectiveness and did not fully assess the relevant outputs in determining hedge effectiveness. At a minimum, the staff expects registrants to consider the coefficient of determination (R-squared), the slope coefficient and t or F-statistics to conclude whether the hedge has been highly effective. The staff expects that if a registrant applies statistical techniques, it should have a thorough understanding of how to use and appropriately evaluate such techniques. This may necessitate the use of of statistical specialists.

Loan commitments

The Derivative Implementation Group (DIG) concluded in DIG Issue C-13, *Scope Exceptions: When a Loan Commitment Is Included in the Scope of Statement 133*, that loan commitments for the origination of mortgages that will be held for sale are derivatives under FAS 133 and should be recorded at fair value. The staff notes that there is diversity in practice regarding the valuation of these loan commitments. Some registrants believe the initial measurement of these loan commitments should result in an asset. Others conclude the initial value is zero, and a few registrants are valuing them as liabilities. The staff has expressed its view that loan commitments recognized as derivatives under FAS 133 are never assets. They are written options that should be recognized and valued by the issuer as liabilities with an offsetting debit to the income statement to the extent consideration for the loan commitment is not received. The staff expects that these recognized loan commitments would continue to be reported at fair value as liabilities until contract expiration or termination.

The staff will not object if registrants discontinue the practice of recognizing loan commitments as assets beginning with loan commitments entered into during the first reporting period beginning after March 15, 2004. Any previously recognized assets for loan commitments should be "taken care of" in the normal course of closing loans in the mortgage pipeline.

The staff reminded participants to disclose, in accordance with SAB 74, *Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant when Adopted in a Future Period*, the upcoming change in accounting policies and the impact of the change in any filings that pre-date this change.

The staff plans to issue a Staff Accounting Bulletin containing its views on this issue.

Subsequent Measurement of Guarantees

Under FASB Interpretation (FIN) 45, *Guarantor's Accounting And Disclosure Requirements For Guarantees Including Indirect Guarantees of Indebtedness of Others*, a guarantor is required to record a liability for certain guarantees at the fair value of the guarantee upon its issuance. FIN 45 is silent on how to subsequently adjust such liability. FASB Staff Position (FSP) FIN 45-2, *Whether FIN 45 Provides Support for Subsequently Accounting for a Guarantor's Liability at Fair Value*, states that subsequent to issuance, guarantees should be accounted for using a method supported by GAAP.

Despite its long-standing position that written options should be accounted for at fair value, the staff has indicated that subsequently measuring guarantees at fair value generally would not be appropriate. The staff believes a systematic

and rational amortization method would most likely be the appropriate accounting.

Equity Method Investments

Determination of significant influence

As a result of recent abuses in the application of Accounting Principles Board (APB) No. 18, *The Equity Method of Accounting for Investments in Common Stock*, the staff reiterated that the determination of significant influence should include an analysis of all means through which an investor might influence the financial and operating policies of an investee (i.e., board representation, veto rights, voting preferred stock). The equity method must be applied in situations where investors have significant influence over the investee and hold securities that function as “in substance” common stock. The EITF is currently addressing the scope of the equity method of accounting in EITF 02-14, *Whether the Equity Method of Accounting Applies When an Investor Does Not Have an Investment in Voting Stock of an Investee but Exercises Significant Influence through Other Means.*”

Purchase price allocation

Purchase price allocations are required in acquisitions of equity method investees. The staff encourages registrants to review and ensure they have properly accounted for these transactions (i.e., that tangible assets are stepped up to fair market value and intangible assets are properly identified and subsequently accounted for).

Asset Retirement Obligations

In situations where leases require or permit the lessee to return the leased property to its original con-

dition, the staff notes that both FAS 13, *Accounting for Leases*, and FAS 143, *Accounting for Asset Retirement Obligations* have been applied. Because the FASB has declined to provide specific guidance on the treatment of these obligations, the staff has not objected to either approach as long as it is consistently applied.

The staff has addressed certain issues that have arisen in the application of both standards. For registrants that apply FAS 13, the staff does not believe that the obligation qualifies as contingent rent. Therefore the lessee should accrue the settlement costs over the lease term, if the lease is an operating lease or include the present value of the estimated costs as part of the asset if the lease is a capital lease.

In the application of FAS 143, the staff reminded registrants that uncertainties involving the estimation of the settlement date or the probability that the lessor would enforce the obligation would affect the measurement of the liability but would not effect whether a liability is recognized. In estimating the settlement date, the staff noted different analyses that have been applied and suggested probability-weighted assessments as an appropriate approach to address the uncertainty of the timing of the settlement. In assessing the likelihood of the enforcement of the obligation, registrants should consider all available information even if it is not company or industry specific. In situations where a lease contains an unambiguous obligation, unless there is history of past non-enforcement, a registrant should assume performance would be required.

Income Taxes

Previously, the staff has noted that the financial statement effects of tax planning strategies are not

always apparent. However, the impact of such strategies, if material, should be disclosed (e.g., through the effective rate reconciliation required under Rule 4-08(h) of Regulation S-X or through disclosure requirements under FAS 5, *Accounting for Contingencies*).

The staff has also expressed its views on tax planning strategies with the focus on the recognition and measurement of the associated contingent tax benefits. In the view of the staff, the gross amount of a contingent tax asset may only be recognized if the company and the auditors conclude that it is probable that the deduction will be sustained. For example, a tax opinion stating the deduction is probable of being sustained would likely support a reduction to current taxes payable; a tax opinion indicating that realization is something less than probable would not. This threshold question of whether or not the tax benefit can be recognized is different than the requirement under FAS 109, *Accounting for Income Taxes*, to recognize a valuation allowance if it is “more likely than not” that a deferred tax benefit will not be realized.

Additionally, the staff has clarified that any temporary income tax difference should be measured as the difference between the financial reporting basis and the probable (not as-filed) tax basis. In essence, a contingent income tax liability, if required under FAS 5, should be recognized, based on the difference between the probable and as-filed tax basis. This contingent income tax liability should not be included with deferred income tax liabilities or as any part of a valuation allowance.

The staff has acknowledged, however, that some companies continue to measure temporary differences as the difference between the financial reporting and as-filed tax basis, thereby including the

contingent tax liability as part of the deferred income tax liability. Although the staff has not considered the basis for such an accounting model, they believe that if applied, the components of the deferred income tax liability should be disclosed and be on a consistent basis period to period.

Interaction of the Deferral of FAS 150 and EITF Topic D-98

In November 2003, the FASB issued FSP FAS 150-3, *Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*. The deferral of the effective date of FAS 150 applies only to certain mandatorily redeemable noncontrolling interests (that is, minority interests) in consolidated financial statements. The effective date is delayed differently depending on the type of mandatorily redeemable noncontrolling interest. The effective date of FAS 150 remains unchanged for mandatorily redeemable shares issued by the parent company, written put options on a company's shares, forward purchase contracts for a company's shares, and contracts that require the issuance of shares in amounts unrelated to, or inversely related to, the value of the shares.

The staff reminds entities to refer to EITF Topic D-98, *Classification and Measurement of Redeemable Securities*, for guidance related to classification and/or measurement for those securities that will not be fully accounted for in accordance with FAS 150 as well as for those securities which are not included in the scope of FAS 150.

Other Issues

- FIN 46 *Consolidation of Variable Interest Entities* – when the FASB issued FIN 46(R) in December, 2003, it provided a limited scope exception to variable interest entities created before December 31, 2003, if an enterprise, after exhaustive efforts, is unable to obtain the information necessary to apply the provisions of FIN 46 (R). The staff anticipates that the use of the exception will be infrequent. In assessing whether exhaustive efforts have been expended, the staff expects consideration of whether other registrants in the same industry with similar arrangements have been able to obtain the necessary information.
- Segment reporting – aggregation of segments must be consistent with the objectives and principles of FAS 131, *Disclosures about Segments of an Enterprise and Related Information*. Under paragraph 17, operating segments may be aggregated only if they meet five specific criteria and they have similar economic characteristics. In evaluating whether segments have similar economic characteristics, the staff has emphasized that registrants should focus on the measures used by management to evaluate performance. Specifically, the staff has indicated that average gross margin, although cited as an indicator in FAS 131, may not be the most relevant measure for all companies. Also, registrants should consider a reasonable period of time for both past historical results and future estimates of financial performance.
- FAS 142 – any change in the date used for the annual impairment assessment for goodwill represents a change in accounting principle and would require a preferability letter from the registrant's auditors.
- Financing of trade payables – Article 5 of Regulation S-X requires that an entity separately disclose on its balance sheet amounts relating to borrowings from financial institutions and amounts payable to trade creditors. If a lender pays vendor invoices on behalf of a customer at net (taking advantage of discount afforded early payment) and the customer subsequently pays the lender at gross, the trade payables recorded on the books of the customer should be derecognized under FAS 140 and the debt to the lender should be recorded. The difference between the gross and net amounts should be reflected as a debt discount and accreted through interest expense over the life of the debt.
- Consolidation of bankrupt subsidiaries – although bankruptcy is generally indicative of a loss of control, continuing consolidation under FAS 94 may be appropriate if the results are more meaningful, the loss of control is temporary and no significant uncertainties exist. For example, consolidation may be appropriate if the parent will have voting control after the subsidiary's emergence from bankruptcy and the emergence will be within one year. Such situations are expected to be infrequent and should be based on the specific facts and circumstances after consultation with the staff.
- Accounting by mining companies – The staff meets periodically with the AICPA International Practices Task Force, a

subcommittee of the AICPA SEC Regulations Committee. The staff has chosen to use these meetings as the vehicle through which it communicates its views on certain issues impacting the mining industries (both domestic and foreign). Minutes of the meetings, including discussions and conclusions reached, are available at the AICPA's website at www.acipa.org/belt/sec-hl.htm.

SEC Reporting Issues

Many of the issues the staff continues to focus on are the same as the ones the staff covered in its February 2003 report on the reviews it performed during 2002 of the annual reports of the Fortune 500 companies. (That report, *Summary by the Division of Corporation Finance of Significant Issues Addressed in the Review of the Periodic Reports of the Fortune 500 Companies*, may be found at: <http://www.sec.gov/divisions/corpfin/fortune500rep.htm>.) That report covered the issues listed below.

- MD&A
- Critical accounting policy disclosures
- Non-GAAP financial information
- Revenue recognition
- Restructuring charges (financial statement and MD&A issues)
- Impairment charges related to long-lived assets, securities held for investment, goodwill, and other intangible assets
- Pension plans
- Segment reporting
- Securitized financial assets and off-balance sheet arrangements
- Environmental and product liability disclosures

The staff's views on some of these and other areas of focus follow.

Management's Discussion and Analysis

The staff has frequently provided suggestions for improving the usefulness of MD&A to investors by using plain English, more tabular presentations, less discussion, and more analysis; emphasizing the most important information, identifying risks, and using estimates. The staff believes that MD&A typically provides plenty of discussion but often falls short on management and analysis. In December of 2003, the Commission reinforced this message by issuing Release 33-8350, *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations*, which provides further interpretive guidance related to MD&A. This interpretive release can be found at <http://www.sec.gov/rules/interp.shtml>. The content of the new release, as well as frequent staff comments related to MD&A are highlighted below.

In order for MD&A to be meaningful, it must accomplish three principal objectives:

- Enable investors to see the company through the eyes of management.
- Enhance overall financial disclosure and provide the context for analysis.
- Provide information so investors can ascertain the likelihood that past performance is indicative of future performance.

Critical to the process of preparing MD&A is the involvement of the right people. There should be substantial participation from executive level management from all functional areas of the company (not just finance).

Providing an executive summary can enhance a reader's understanding of the business and provide a context from which to gauge the relative significance of the

events discussed in MD&A. The summary should describe the underlying economics of the business from senior management's perspective. It should identify the most relevant factors impacting the business and matters with which senior management is most concerned.

Preparers of MD&A should keep in mind that there is no required format or style for MD&A, and not all information is of equal importance. Management should avoid the tendency to simply carry over MD&A material from year to year, as some events that were material in past years may no longer be relevant. The discussion should begin with the most important matters affecting the company, even if those matters are of a non-financial nature. In discussing financial matters, the use of tables, charts and graphs can often enhance a reader's understanding of the subject.

MD&A should provide meaningful analysis of all important events – it should communicate not just what happened, but why it happened. In addition, the analysis should explicitly identify known trends associated with important events and whether or not management believes these trends will continue. The SEC's rules on MD&A specifically require discussion of known trends and uncertainties with respect to each required section of MD&A (i.e. liquidity, capital resources, results of operations and off-balance sheet arrangements).

The liquidity section of MD&A should concentrate on cash requirements (what bills the company has) and sources of cash (how the company will pay those bills). The discussion should describe the underlying drivers of cash inflows, the extent of reliance on sources of cash inflows, and how the timing of inflows impacts cash outflows. Management should not simply

recite the cash flow statement line by line, but should provide meaningful analysis of *why* liquidity changed, not just how it changed.

The staff views the table of contractual obligations, which is required for fiscal years ending on or after December 15, 2003 (for other than small business issuers), as critical to an understanding of liquidity. The table should include all contractual obligations required by the rules, whether or not included elsewhere in the filing. Management should use its judgment in deciding how to present its company's obligations, particularly items such as purchase obligations and pension and other post-employment benefit obligations. The staff believes that material funding requirements with respect to pension and other post-employment benefits should be included in the table if material payments are expected. Purchase obligations should be aggregated and presented on the purchase obligations line. If the company is unable to compile the necessary information for all purchase obligations (such as open purchase orders), it should include footnotes that explain what was omitted from the table and the significance of the omission to the company's aggregate purchase obligations. The footnotes should provide a reasonable explanation as to why information was omitted from the table, and companies should consider whether the inability to aggregate all purchase obligations is an internal control weakness.

Since final rules have not been issued on critical accounting policies and estimates, FR 60 (*Cautionary Advice Regarding Disclosure About Critical Accounting Policies*), which was issued in December 2001, is the official applicable guidance. However, the staff believes that the proposed rules in Release 33-8090, *Disclosures in Management's Discussion*

and Analysis about the Application of Critical Accounting Policies, also call for disclosures that investors will find useful. Therefore, registrants should also consider the disclosures called for in that proposal when preparing their disclosures. The staff will be reviewing the quality of critical accounting policy and estimate disclosures during the 2003 10-K season in order to determine whether to recommend adoption of some version of the rules that were proposed in 2002. MD&A discussion of critical accounting estimates should focus on the uncertainty in the most significant estimates and not simply reiterate the accounting policies section of the financial statement footnotes. Specific areas where discussion and analysis of company estimates was lacking in 2002 filings include loss contingencies, restructuring charges and impairment charges. The discussion surrounding these types of estimates often lack any forward-looking insight, such as the impact of the charges on future operations and discussion of the company's plans going forward after the events that gave rise to the charges have taken place. The staff may question the timing of the disclosures surrounding impairment charges. Potential impairments should first be discussed in the period that the trends, events and uncertainties occur- not the period of the charge. The existence of a triggering event that gave rise to an impairment test should be disclosed in MD&A, even if no impairment charge resulted from the test.

The use of non-GAAP financial measures are permitted in MD&A; however the staff will evaluate the context within which the non-GAAP measure is used in determining whether it is misleading. (See further discussion below.)

Non-GAAP Financial Measures

The staff has discussed common problems in applying the new rules covering non-GAAP financial measures contained in Item 10(e) of Regulation S-K and the guidance in the related Frequently Asked Questions document. (These rules are discussed in our *Financial Reporting* letter at http://www.bdo.com/about/publications/assurance/fr_mar_24_03/ and in our *Sarbanes-Oxley Act Implementation Reference Guide* at <http://www.bdo.com/services/assurance/sarbanes/RefGuide.pdf>. The staff's FAQ document may be found at <http://www.sec.gov/divisions/corpfin/faqs/nongaapfaq.htm>.)

The issue to which the staff has devoted the most attention is the high hurdle registrants must meet to be permitted to present a non-GAAP financial measure that eliminates a recurring item (for example, when a registrant presents EBITDA as a measure of operating performance). This issue is covered in questions 8 and 9 of the FAQ document. The staff has reminded registrants that while there is no specific prohibition against excluding a recurring item, their disclosures must meet the burden of demonstrating the usefulness of any measure that excludes a recurring item. The staff believes that this is usually quite difficult. For example, the staff believes that it is difficult to justify the usefulness of EBITDA as a performance measure in a capital-intensive industry because EBITDA excludes a key cost (depreciation expense) that must be incurred to produce the revenue reflected in that measure.

A registrant's disclosures that are aimed at justifying the use of a non-GAAP financial measure that excludes a recurring item must provide substantive reasons why the measure is useful to investors and how it is used by management. In

that regard, the disclosure should provide a meaningful discussion of:

- The manner in which management uses the measure to conduct or evaluate its business;
- The economic substance behind management's decision to use the measure;
- The material limitations associated with use of the measure as compared to the use of the most directly comparable GAAP financial measure;
- The manner in which management compensates for these limitations when using the measure; and
- The substantive reasons why management believes the measure provides useful information to investors.

The staff expects these disclosures to be company specific. They should not consist of boilerplate language that is much the same as other companies would provide. In addition, if more than one such measure is used, the reasons why management believes the measure provides useful information should differ for each measure. Further, if the stated manner in which management uses the measure is consistent with the principles of segment reporting in FAS 131, (i.e., the measure is used to allocate resources and assess performance), the staff would expect to see the same measure provided in the segments disclosure.

FIN 46

The staff has clarified a number of reporting and disclosure issues related to implementing FIN 46, in addition to the accounting issue discussed above.

Financial statement and MD&A disclosures

The staff reminded registrants that pre-adoption filings must provide,

in addition to the disclosures required by paragraph 26 of FIN 46 (paragraph 27 of FIN 46R), the disclosures called for by SAB 74.

In filings covering the period of adoption, the financial statements should disclose, in addition to the information called for by paragraphs 23-25 of FIN 46 (paragraphs 23-26 of FIN 46R), the following:

- The principles for including or excluding a variable interest entity (VIE);
- The entities consolidated as a result of adopting FIN 46 and why; and
- Any material restrictions on the registrant's ability to use assets reflected on the consolidated balance sheet.

In filings covering the period of adoption, the MD&A should disclose the following matters, which may be caused or affected by consolidating a VIE:

- Known trends in operating results or financial condition;
- Uncertainties and their potential impact; and
- Liquidity matters, such as loan covenant violations or restrictions on the ability to use cash reflected on the consolidated balance sheet.

In addition, all filings must provide the new off-balance sheet arrangement disclosures called for Item 303(a)(4) of Regulation S-K.

Acquisition and disposition reporting

Rule 3-05 of Regulation S-X requires registrants to provide financial statements of significant acquired businesses in registration statements. Form 8-K contains similar requirements and also requires registrants to report significant acquisitions of assets and significant dispositions of assets and businesses. The staff has been considering the extent to which these requirements should apply when a registrant consolidates or

deconsolidates a VIE. The staff has not completed its deliberations on this issue. However, its current thinking is as follows.

A registrant may consolidate or deconsolidate a VIE in connection with its transition to FIN 46. The adoption of a new accounting standard is not an "extraordinary corporate event" that requires reporting under Rule 3-05 or Form 8-K. Registrants should inform investors about the effects of the accounting change through financial statement and MD&A disclosures.

After adoption, if a registrant consolidates or deconsolidates a VIE, this would generally require it to consider the reporting requirements of Rule 3-05 and Form 8-K. In doing so, a registrant would need to consider the following:

- The form of its variable interest (e.g., asset, obligation or executory contract);
- Whether the event occurred in the ordinary course of business;
- The significance thresholds in Rule 3-05 and Form 8-K; and
- Whether the VIE meets the definition of a business in Rule 11-01(d) of Regulation S-X (not EITF 98-3).

In evaluating these considerations the staff has indicated that it will look to the needs of the investor in determining if the reporting requirements would apply.

Rule 3-10 of Regulation S-X and trust preferred securities

Some registrants raise capital by entering into arrangements where (1) a trust is formed and issues preferred securities, (2) the trust loans the proceeds to the registrant, and (3) the registrant guarantees the trust's obligations with respect to its preferred securities. In the past, registrants have generally consolidated such trusts. However, consolidation generally is not appro-

priate under FIN 46. If the trust's preferred securities and the registrant's guarantee are registered and the registrant deconsolidates the trust, this raises issues under Rule 3-10 of Regulation S-X and Exchange Act Rule 12h-5. These rules can exempt a registrant from providing the trust's financial statements in its filings and exempt a trust from Exchange Act reporting if certain conditions are met.

The staff has announced that it will accommodate the continued use of the exemptions in these rules in situations where the trust is deconsolidated as long as the trust meets the definition of a finance subsidiary in Rule 3-10(h)(7), the other conditions in Rule 3-10(b) are met, and the disclosures required by Rule 3-10(b)(4) are provided. In addition, the guarantor must disclose the reasons for deconsolidating the trust and the impact of deconsolidation on the guarantor's financial statements.

Discontinued Operations

When a component of an entity that has been disposed of or is held for sale is reported as a discontinued operation, the financial statements for prior periods must be restated to report the component's operating results in discontinued operations. These restatements can give rise to a number of reporting questions. In addition, these questions are arising more frequently, because FAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, changed the criteria pursuant to which a component must be reported as a discontinued operation. Under the criteria in FAS 144, more components must be reported as discontinued operations than would have been reported as such under the previous criteria in APB 30, *Reporting the Results of Operations-Reporting the*

Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions. The staff has provided guidance on a number of issues related to restatements to report discontinued operations.

Mechanics of restatements in registration statements

If a registrant first reports discontinued operations in an interim period, it must restate its prior years' annual financial statements previously reported in its Form 10-K before it can include them or incorporate them by reference in a registration statement. It can, of course, do this by presenting restated financial statements in the registration statement. Alternatively, a registrant filing a registration statement that permits incorporation by reference in lieu of presenting the financial statements could opt to file the restated financial statements under Item 5 of Form 8-K and incorporate that Form 8-K by reference into the registration statement. When a registrant follows this approach, it should also file a revised MD&A that discloses the following:

- The circumstances leading to the discontinuance;
- The revenues, costs, and margins from the continuing operations;
- Any contingencies, commitments, or continuing involvement with the discontinued operation; and
- The expected impact of the discontinuance on the registrant's business and financial condition.

The restated financial statements and MD&A should *not* be filed by amending the Form 10-K. Since the Form 10-K was correct when it was filed, it would not be appropriate to amend it. Amending the Form 10-K might lead investors to inappropriately think something was wrong with it when it was filed.

If the discontinued operation is considered to be a fundamental change, then a post-effective amendment would be required for an S-3 shelf filing.

Timing of restatements in registration statements

Under FAS 144, a component is not reported as a discontinued operation until a registrant issues financial statements covering the period during which the component first meets the criteria for discontinued operations reporting. Until that time, registrants should present pro forma information to provide investors with information about the effects of actual or probable discontinuances. Pro forma information should be provided when:

- The criteria to report the component as a discontinued operation were first met after the date of the latest financial statements included/incorporated by reference in the filing or
- The criteria have not been met, but it is probable that events requiring discontinued operations reporting will occur.

Impact on significance calculations

In applying Rules 3-05 and 3-09 of Regulation S-X and Item 2 of Form 8-K, registrants must calculate the significance of acquired businesses and equity method investees, in order to determine whether audited financial statements are required, and if so, for how many years. The denominators in these calculations come from a registrant's historical financial statements. The staff has provided the following guidance on how these calculations are affected by restatements for discontinued operations:

- For acquired businesses, significance calculations made before the discontinuance do not have to be changed. Signi-

finance calculations using the restated financial statements are only required for businesses acquired after restated financial statements are filed and for probable acquisitions.

- A registrant is not required to recalculate the significance of its equity method investees until the next Form 10-K filing. At that time significance must be recalculated, and this could trigger the need for investee audited financial statements that had not been required in the past.
- A registrant can continue to use the originally filed 10-K for purposes of determining the materiality of aggregating individually insignificant acquisitions.

Accelerated Filings

The Commission adopted accelerated filing rules in 2002, and they will require some companies to file their periodic reports on an accelerated timetable (beginning with annual reports for years ended on or after December 15, 2003). (These rules are discussed in our *Financial Reporting* letter at http://www.bdo.com/about/publications/assurance/fr_sept_0230/ and in our *Sarbanes-Oxley Act Implementation Reference Guide* at <http://www.bdo.com/services/assurance/sarbanes/RefGuide.pdf>.) Several questions have arisen regarding how these rules affect target company and pro forma financial statements.

The timetable for updating target company historical financial statements in a Form 8-K or registration statement depends on whether the target is an accelerated filer. Thus, when a publicly held target company is an accelerated filer, its financial statements appearing in an acquirer's filing must always be as current as the financial statements it filed in its own reports. Thus, in Form 8-K and

registration statement filings where one company (i.e., either the acquirer or the target) is an accelerated filer and the other is not, it may be necessary to update the historical financial statements of one of the companies but not the other.

With respect to pro forma financial statements, the staff has discussed an example where the registrant was required to update its historical financial statements to June 30, but the target was not required to update its historical financial statements beyond March 31. Although Article 11 of Regulation S-X would not require more current target financial information for purposes of preparing pro forma financial statements, the staff believes that target amounts as of and for the period ended June 30 should be used if they are available. These amounts should be used even if the target's complete interim financial statements are not available. If this is done, the filing should explain that the target's historical financial statements included in the filing depict a different period and why.

Reports of Unregistered Accounting Firms

Domestic public accounting firms that audit or play a substantial role in the audit of the financial statements of an SEC registrant were required to register with the Public Company Accounting Oversight Board (PCAOB) by October 22, 2003. The staff discussed a number of issues that have arisen as a result of this requirement.

Principal auditor does not register

If an accounting firm that audited a registrant's financial statements in the past decides not to register, the registrant will need to engage a

registered firm to audit its subsequent financial statements. The staff commented that in this situation, the firm that did not register can reissue its report on the prior financial statements and issue consents to the use of that report in registration statements. However, that firm cannot do any work to update its report. Thus, if a registrant restates its prior financial statements (e.g., to report a discontinued operation), it would generally have to have those financial statements reaudited by a registered firm.

Target company financial statements

Financial statements provided pursuant to Rule 3-05 of Regulation S-X and Item 2 of Form 8-K are not financial statements of issuers. Therefore, an accounting firm does not need to be registered with the PCAOB to audit such financial statements.

Equity method investee financial statements

Under Rule 3-09 of Regulation S-X, a registrant must file the financial statements and auditors' report relating to an equity method investee if that investee meets certain significance tests. The staff is still considering the question of whether an accounting firm needs to be registered with the PCAOB to audit the financial statements of an equity method investee whose financial statements must be filed pursuant to Rule 3-09. Until this question is resolved, registrants should contact the staff to discuss the matter if they expect to file an investee's auditors' report pursuant to Rule 3-09 and that auditor has not registered with the PCAOB.

Guarantor financial statements

Since guarantees of registered securities (e.g., guarantees of debt

securities) are securities themselves, an issuer of such a guarantee meets the definition of an issuer in the PCAOB's registration rules. Therefore, auditors of the financial statements of guarantors of registered securities, required to be filed with the SEC pursuant to Rule 3-10 of Regulation S-X, must register with the PCAOB.

Other Issues

- Auditing Rule 3-10 Consolidating Financial Information – under Rule 3-10 of Regulation S-X, the separate audited financial statements of guarantors or issuers of registered securities may be omitted if certain conditions are met. In some fact patterns, registrants must include, in a footnote, audited condensed consolidating financial information as of the same dates and for the same periods as those for which audited consolidated financial statements are presented. The staff announced that it will make an accommodation to registrants (1) that are registering guaranteed debt securities for the first time and (2) whose earliest of the three years presented was audited by Arthur Andersen LLP. In this fact pattern, the staff will not object if the condensed consolidating financial information for the earliest of the three years presented is unaudited.
- Access to correspondence – a company that provides SEC filing access services had used the Freedom of Information Act to obtain and make available to its subscribers copies of thousands of staff comment letters on registrant filings and the registrants' responses. A senior staff lawyer has observed that this might lead to an increase in the frequency with which registrants request confidential

treatment for matters covered in response letters. He noted that Rule 83 (17 CFR 200.83) of the Commission's Rules of Practice governs applications for confidential treatment of such information. The SEC's website provides further information about Rule 83 at <http://www.sec.gov/foia/conftrat.htm>.

- Certifications required under Section 302 of the Sarbanes-Oxley Act – if a company files an amended periodic filing (e.g. 10-K/A, 10-Q/A, 20-F/A) the Section 302 certifications are required to be included in the amended filing. However, if the filing does not include financial statements, the certifications only need to include items 1 and 2.

International Reporting Issues

During the year, the staff performed reviews of annual reports for large foreign private issuers (typically filed on Form 20-F). These reviews identified instances where foreign private issuers and/or their auditors were unfamiliar with certain existing rules/regulations. As a result, the staff has focused on reemphasizing certain rules/regulations, as discussed below.

Financial Statement Issues

Consolidation

Under Form 20-F, the content of foreign private issuers' financial statements should be substantially similar to financial statements prepared in accordance with U.S. GAAP. As such, although home-country GAAP may allow an exemption from consolidation for immaterial subsidiaries, the staff will not. Consolidated financial state-

ments in SEC filings must include all subsidiaries.

Error Corrections

If financial statements filed with the SEC contain a material error, they must be restated in an amended filing. This requirement applies even in situations where home-country GAAP or home-country laws prohibit such restatements.

Adoption of New Standards

Many U.S. GAAP standards now require initial adoption for periods "beginning after" a certain date. To assist foreign private issuers in determining the proper period for application of such standards, a general model has been developed. Under the model, a "period" would be determined by the frequency with which a registrant publishes U.S. GAAP financial information. For example, FIN 46 originally required adoption for certain variable interest entities in annual or interim periods beginning after June 15, 2003. For a foreign private issuer with a calendar year-end that only provides U.S. GAAP compliant information on an annual basis, this interpretation would be effective on January 1, 2004. As such, any subsequent deferrals of the effective dates (e.g., FIN 46 to periods ending after December 15, 2003) that would accelerate the original effective date would not apply.

Auditor Related Issues

Qualifications

An audit firm must meet certain qualification requirements to have its report included in an SEC filing. The staff has reminded registrants that these requirements would also apply to any other audit reports included in a filing (e.g., relating to subsidiaries, equity investees, tar-

get companies, and guarantors). However, the staff has indicated that they allow limited exceptions for auditors of target companies if they will not be the continuing auditor and will not be otherwise practicing before the SEC.

The requirements include, but are not limited to the following:

- A non-U.S. auditor must either be affiliated with a U.S. firm that follows Appendix K to the SECPS membership rules, subsequently adopted by the PCAOB, (e.g., relating to filing reviewers, inspection procedures) or must demonstrate to the staff its knowledge and experience in applying U.S. GAAP, U.S. GAAS, and SEC financial reporting and independence rules.
- An auditor must be licensed in the jurisdiction in which the audit report is signed.
- Only a U.S. auditor may issue a report for an audit conducted in the U.S.

Additionally, to qualify as the principal auditor a firm must audit the majority of revenues and assets of the consolidated entity. If the principal auditor relies on and refers to subsidiary or equity investee auditors in its report, the reports of the other referenced auditors must also be included in the SEC filing as required by Rule 2-05 of Regulation S-X.

Although audits are generally required to be conducted in accor-

dance with U.S. GAAS, there is no requirement to use the U.S. GAAS style report. However, in situations where there is substantial doubt about an entity's ability to continue as a going concern, the modified wording in the audit opinion must include unconditional language and specifically state that there is "substantial doubt about.... ability to continue as a going concern."

Reporting Issues

Non-GAAP Measures

A foreign private issuer may include an otherwise prohibited non-GAAP financial measure in its filings if the measure is required or "expressly permitted" by the registrant's home-country GAAP applied in its financial statements. The staff indicated that a measure is "expressly permitted" if it is clearly and specifically identified as an acceptable measure under home-country GAAP. A registrant that includes such a disclosure should be prepared to demonstrate why it believes the measurement meets the criteria and should disclose in the filing what the measure represents and why it is used.

Adoption of International Accounting Standards

For fiscal years beginning after January 1, 2005 listed European Union companies (with some exceptions) will be required to pre-

pare their financial standards in accordance with International Accounting Standards (IAS). The rules adopted by the European Commission require companies to present two years of financial statements prepared in accordance with IAS in the year of adoption (e.g., for calendar year companies, 2004 and 2005). However Items 17/18 of Form 20-F require foreign private issuers to present three years of financial statements, prepared on a comparable basis. This would require conversion of an additional year (2003) to IAS for SEC filings. The staff is aware of this inconsistency and is considering various alternatives, one of which may be for the Commission to adopt a rule to provide some form of relief. However, to date, no decisions have been publicly announced.

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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