U.S. Securities and Exchange Commission

Division of Corporation Finance
Current Accounting and Disclosure Issues

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Current Accounting and Disclosure Issues in the Division of Corporation Finance

August 31, 2001

I. Recent Rules, Proposed Rules and Interpretive Bulletins

A. Independence of Auditors and Related Proxy Disclosures

On November 15, 2000, the Commission voted to adopt new rules that modernize the requirements for auditor independence primarily in three areas:

- investments by auditors or their family members in audit clients;
- employment relationships between auditors or their family members and audit clients; and
- the scope of services provided by audit firms to their audit clients.

The new rules also require certain disclosures in annual proxy statements about fees paid for services provided by a company's independent accountant. The new rules reflect the Commission's consideration of comments received on the rules it proposed on June 30, 2000 (Securities Act Release No. 7870). On January 16, 2001, the staff published at www.sec.gov/info/accountants/audindep/audinfaq.htm frequently asked questions and answers about the independence rules and associated proxy disclosure requirements.

Significant features of the new rules

- The rules significantly reduce the number of audit firm employees and their family members whose investments in, or employment with, audit clients would impair an auditor's independence.
- They also identify certain non-audit services that, if provided to an audit client, would impair an auditor's independence. The rules do not extend to services provided to non-audit clients.
- A limited exception is provided to an accounting firm for inadvertent independence violations if the firm has quality controls in place and the violation is corrected promptly.
- Companies must disclose in their annual proxy statements certain information about non-audit services provided by their auditors during the last fiscal year.

Four Principles

A preliminary note to the new rules articulates four principles by which to measure an auditor's independence. An accountant is not independent when the accountant:

- has a mutual or conflicting interest with the audit client,
- audits his or her own firm's work,
- functions as management or an employee of the audit client, or
- acts as an advocate for the audit client.

Financial Relationships

Compared to the previous rules, the newly adopted rules narrow significantly the circle of people whose investments trigger independence concerns. Under the previous rules, many partners in firms that do not

work on the audit of a client, as well as their spouses and families, were restricted from investments in a firm's audit clients. The new rules limit restrictions to principally those who work on the audit or can influence the audit.

Employment Relationships

The employment relationship rules greatly narrow the scope of people within audit firms whose families will be affected by the employment restrictions necessary to maintain independence. The rules also identify the positions, namely those in which a person can influence the audit client's accounting records or financial statements, which impair an auditor's independence if held by a "close family member" of the auditor.

Business Relationships

Consistent with existing rules, independence will be impaired if the accountant or any covered person has a direct or material indirect business relationship with the audit client, other than providing professional services.

General Standard for Auditor Independence

The rule is based on the widely endorsed principle that an auditor must be independent in fact and appearance. The new rule specifies that an auditor's independence is impaired either when the accountant is not independent "in fact" or when, in light of all relevant facts and circumstances a reasonable investor would conclude that the auditor would not be capable of acting without bias. The "reasonable investor" standard is a common construct in securities laws.

Non-Audit Services

The rules identify nine non-audit services that are deemed inconsistent with an auditor's independence. Seven of the nine services were already restricted by the AICPA, SECPS or SEC. The new rules closely track the language found in the existing prohibitions.

- **Bookkeeping or Other Services Related to the Audit Client's Accounting Records or Financial Statements.** Paralleling closely the current prohibition on bookkeeping, an audit firm cannot maintain or prepare the audit client's accounting records or prepare the audit client's financial statements that are either filed with the Commission or form the basis of financial statements filed with the Commission. Exceptions include providing services in emergency situations, provided the accountant does not undertake any managerial actions or make any managerial decisions. Exceptions also include bookkeeping for foreign divisions or subsidiaries of an audit client, provided certain conditions exist.

- **Financial Information Systems Design and Implementation.** The auditor cannot operate or supervise the operation of the client's IT systems. However, the auditor can provide IT consulting services if certain criteria are met. These criteria specify that management must

- acknowledge to the auditor and audit committee management's own responsibility for the client's system of internal controls,
- identify a person within management to make all management decisions with respect to the project,
- make all the significant decisions with respect to the IT project,
- evaluate the adequacy and results of the project, and
- not rely on the accountant's work as the primary basis for determining the adequacy of its financial reporting system.

The prohibition does not include services an accountant performs in connection with the assessment, design, and implementation of internal accounting controls and risk management controls.

- **Appraisal or Valuation Services or Fairness Opinions**. The new rule bans all valuation and appraisal services. Its restrictions apply only where it is reasonably likely that the results of any valuation or appraisal would be material to the financial statements, or where the accountant would audit the results.

- **Actuarial Services**. Closely tracking the SECPS prohibition on actuarial services, actuarial-oriented advisory services are limited only when they involve the determination of insurance company policy reserves and related accounts. Certain types of actuarial services can be performed if the audit client uses its own actuaries or third party actuaries to provide management with the primary actuarial capabilities, management accepts responsibility for actuarial methods and assumptions, and the accountant does not render actuarial services to an audit client on a continuous basis.

- **Internal Audit Services**. An audit firm will be allowed to perform up to 40 percent (measured in terms of hours) of an audit client's internal audit work. The rule does not restrict internal audit services regarding operational internal audits unrelated to accounting controls, financial systems, or financial statements. The rule provides an exception for smaller businesses by excluding companies with less than $200 million in assets. Providing any internal audit services for an audit client, however, is contingent on management taking responsibility for and making all management decisions concerning the internal audit function.

- **Management Functions**. Consistent with previous SEC rules, an auditor's independence is impaired under the new rules when the accountant acts, temporarily or permanently, as a director, officer, or employee of an audit client, or performs any decision-making, supervisory, or ongoing monitoring function for the audit client.

- **Human Resources**. Closely paralleling the SECPS rules, an auditor is not permitted to recruit, act as a negotiator on the audit client's behalf, develop employee testing or evaluation programs, or recommend, or advise that the audit client hire, a specific candidate

for a specific job. An accounting firm can, upon request by the audit client, interview candidates and advise the audit client on the candidate's competence for financial accounting, administrative, or control positions.

- **Broker-Dealer Services**. Consistent with current AICPA rules, an auditor cannot serve as a broker-dealer, promoter or underwriter of an audit client's securities.

- **Legal Services**. An auditor cannot provide any service to an audit client under circumstances in which the person providing the service must be admitted to practice before the courts of a U.S. jurisdiction.

- **Contingent Fee Arrangements.** The rules reiterate that an accountant cannot provide any service to an audit client that involves a contingent fee.

- **Quality Controls.** The rules provide a limited exception from independence violations to the accounting firm, if certain factors are present:

  - The individual did not know the circumstances giving rise to his or her violation.

  - The violation was corrected promptly once the violation became apparent.

  - The firm has quality controls in place that provide reasonable assurance that the firm and its employees maintain their independence. For the largest public accounting firms, the basic controls must include, among others, written independence policies and procedures, automated systems to identify financial relationships that may impair independence, training, internal inspection and testing, and a disciplinary mechanism for enforcement.

- **Proxy Disclosure Requirement**

  - Companies must disclose in their annual proxy statements the fees for audit, I/T consulting and all other services provided by their auditors during the last fiscal year. Items 9(e)(1), (2) and (3) of Schedule 14A require that each of these amounts be provided under a specified caption. One way to satisfy this requirement is to provide a table consisting of two columns or rows, the first listing the three captions and the second listing the three amounts. Any further breakdown of the amounts is optional and could be included in the table itself, in a footnote to the table or in narrative disclosure in proximity to the table. The amount designated as audit fee must include only fees for financial statement audit and review services performed by the auditor that are customary under generally accepted auditing standards or that are customary for the purpose of rendering an opinion or review report on the financial statements.

- Companies must also state whether the audit committee has considered whether the provision of the non-audit services is compatible with maintaining the auditor's independence.

- The registrant is required to disclose also the percentage hours worked on the audit engagement by persons other than the accountant's full time employees, if that figure exceeded 50 percent. This requirement responds to recent moves by some accounting firms to sell their practices to financial services companies. The partners or employees often become employees of the financial services firm. The accounting firm then leases assets, namely auditors, back from those companies to complete audit engagements. In such cases, most of the auditors who work on an audit are employed elsewhere unbeknownst to the public.

- Item 9(e) of Schedule 14A does not specify where in the proxy statement the disclosures must appear. Many companies present together the disclosures required by Item 7(e) and Items 9(a)-(e) of Schedule 14A. However, the safe harbor in Item 7(e)(3)(v) of Schedule 14A applies only to information required to be disclosed under Item 7(e)(3) and the safe harbor in Item 306(c) of Regulation S-K applies only to information required to be disclosed by Items 306(a) and (b) of Regulation S-K and, therefore, neither safe harbor covers disclosures required by Item 9(e) but included in the audit committee report.

B. Revenue Recognition Guidance (SAB 101, 101A&B, and FAQ)

On December 3, 1999, the staff published Staff Accounting Bulletin 101 to provide guidance on the recognition, presentation and disclosure of revenue in financial statements (www.sec.gov/interps/account/sab101.htm). The SAB draws on the existing accounting rules and explains how the staff applies those rules, by analogy, to transactions that the accounting literature does not otherwise address specifically. On October 12, 2000 the staff published Frequently Asked Questions and Answers which responds to inquiries received from auditors, preparers and analysts about how the accounting literature and guidance in SAB 101 should be applied (www.sec.gov/info/accountants/sab101faq.htm).

SAB 101 identifies basic criteria that must be met before registrants can record revenue:

- persuasive evidence of an arrangement exists;
- delivery has occurred or services have been rendered;
- the seller's price to the buyer is fixed or determinable; and
- collectibility is reasonably assured.

In the absence of authoritative literature addressing a specific arrangement or a specific industry, the staff believes preparers and auditors should

assure that the company's revenue recognition policy satisfies all of these criteria.

Specific fact patterns discussed in the SAB include bill-and-hold transactions, long-term service transactions, refundable membership fees, contingent rental income, and up-front fees when the seller has significant continuing involvement. The SAB also addresses whether revenue should be presented at the full transaction amount or on a fee or commission basis when the seller is acting as a sales agent or in a similar capacity. Finally, the SAB provides guidance on the disclosures registrants should make about their revenue recognition policies and the impact of events and trends on revenue.

The Q&A provides additional interpretive guidance about the significance of title transfer, the meaning of substantial performance and customer acceptance, the effect of undelivered elements on nonrefundable payments, the conditions for recognition of refundable service revenue, and various SAB 101 implementation questions.

Registrants were expected to change their accounting policies to comply with the SAB. Provided the registrant's former policy was not an improper application of GAAP, registrants adopted a change in accounting principle to comply with the SAB no later than the last fiscal quarter of the fiscal year beginning after December 15, 1999.

C. Materiality in the Preparation or Audit of Financial Statements (SAB 99)

On August 12, 1999, the staff published Staff Accounting Bulletin No. 99. The SAB expressed the staff's view that exclusive reliance on certain quantitative benchmarks to assess materiality in preparing or auditing financial statements is inappropriate. The SAB states that the staff has no objection to the use of a percentage threshold as an initial assessment of materiality, but exclusive use of such thresholds has no basis in law or in the accounting literature. The staff stresses that evaluations of materiality require registrants and auditors to consider all of the relevant circumstances, and that there are numerous circumstances in which misstatements below a benchmark percentage threshold could be material.

The SAB also notes that even though a misstatement of an individual amount may not cause the financial statements to be materially misstated, it may, when aggregated with other misstatements, render the financial statements taken as a whole to be materially misleading. The SAB, therefore, provides guidance on when and how to aggregate and net misstatements to evaluate whether they materially misstate the financial statements. The SAB advises that, even if management and auditors find that a misstatement is immaterial, they must consider whether the misstatement results in a violation of the books and records provisions in Section 13(b) of the Exchange Act.

D. Restructuring Charges, Impairments, and Related Issues (SAB 100)

On November 24, 1999, the staff published Staff Accounting Bulletin No.

100, which provides guidance on the accounting for and disclosure of certain expenses and liabilities commonly reported in connection with restructuring activities and business combinations, and the recognition and disclosure of asset impairment charges. Generally, costs that may be recognized solely pursuant to management's plan to incur them are limited under GAAP to those costs which result directly from an exit activity, are not associated with and do not benefit continuing activities, and for which there is appropriate authorization, specification, and commitment to execute. The SAB expresses the staff's view that a company's exit plan should be at least comparable in its level of detail and precision of estimation to the company's other operating and capital budgets, and should be accompanied by controls and procedures to detect and explain variances and adjust accounting accruals. The SAB discusses disclosures in financial statements and MD&A that are often necessary to make the effects of restructuring activities on reported results sufficiently transparent to investors. Registrants are referred to EITF 94-3 and 95-3 for specific disclosures that should be included in financial statements for the period of the initial restructuring charge and for subsequent periods while the plan is being implemented.

SAB 100 also reminds registrants that the operational requirement to continue to use an asset disallows accounting for the asset as "held for sale." If the asset is held for use, its carrying value must be systematically amortized to its salvage value over its remaining economic life. If management contemplates the removal or replacement of assets more quickly than implied by their depreciation rates, the useful lives of the assets and rates of depreciation must be re-evaluated.

The SAB explains the staff's concern if a registrant records liabilities assumed in a business combination at amounts materially greater than historically reported by the acquired company. That circumstance could indicate that costs incurred before or after the merger were not properly recognized in the reported results of one or the other combining company. The SAB reminds registrants that, if the acquired company's historical accounting for a liability is based on reasonable estimates of undiscounted future cash flows, the estimated undiscounted cash flows underlying the liability recorded by the acquiring company would not be expected to differ materially from those estimates unless the acquirer intends to settle the liability in a manner demonstrably different from that contemplated by the acquired company.

E. Selected Loan Loss Allowance and Documentation Issues (SAB 102)

On July 6, 2001, the staff published Staff Accounting Bulletin (SAB) No. 102, which provides certain views of the staff about the development, documentation, and application of a systematic loan loss allowance methodology. The Commission previously issued guidance on this topic in December 1986 through Financial Reporting Release No. 28 (FRR No. 28). The SAB applies to registrants that are creditors in loan transactions that, individually or in the aggregate, have a material effect on the registrant's financial statements. The SAB does not change any of the accounting profession's existing rules on accounting for loan loss provisions or allowances.

The staff views in the SAB are based on the premise underlying FRR No. 28: loan loss estimates developed without a disciplined methodology or adequate documentation can undermine the credibility of an institution's financial statements. Since the issuance of FRR No. 28, the Commission's staff has continued to observe, from time to time, a lack of discipline in the establishment of allowances for loan losses and situations in which companies may have weaknesses in their documentation related to loan loss allowances. The General Accounting Office has made similar observations about the loan loss allowance practices of depository institutions, as it reported in its October 1994 Report to Congressional Committees, *Depository Institutions: Divergent Loan Loss Methods Undermine Usefulness of Financial Reports*. The SAB provides guidance to registrants to assist them in improving both their systematic methodologies for estimating loan loss allowances and their supporting documentation.

SAB No. 102 covers several topics, including the following:

- A summary of current loan loss allowance guidance under generally accepted accounting principles and Commission rules and interpretations;

- General factors or elements to consider in developing and documenting loan loss allowance methodologies, including in written policies and procedures;

- Staff expectations for documenting loan impairment under FASB Statements No. 114 and No. 5;

- Staff expectations related to summary documentation of the results of a systematic loan loss allowance methodology; and

- General guidance on validating, and documenting the validation of, a systematic loan loss allowance methodology.

The SAB was prepared as a result of the March 10, 1999 Joint Interagency Letter to Financial Institutions signed by the SEC, the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision. In that Joint Letter, the agencies agreed to provide parallel guidance on loan loss allowance methodologies and supporting documentation. The banking agencies issued their parallel guidance on July 6, 2001 through the Federal Financial Institutions Examination Council as interagency guidance, "Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions."

F. Proposed Rule for Disclosure About Valuation and Loss Accruals, Long-Lived Assets

On January 21, 2000, the Commission proposed rule amendments to reposition certain schedule information about valuation and loss accruals that is currently required in exhibits to certain periodic reports and registration statements. (Securities Act Release No. 33-7793) Under the proposed rule, this information would be required by new Item 302(c) of Regulation S-K and be included within the main body of reports and

registration statements. Also, a proposed new Item 302(d) of Regulation S-K would require certain information concerning tangible and intangible long-lived assets and related accumulated depreciation, depletion, and amortization. Amendment of Form 20-F is also proposed to include new Item 8C soliciting identical information in filings by foreign private issuers. The rule proposals are intended to provide investors with (1) more transparent, better detailed disclosures concerning changes in valuation and loss accrual accounts and in the underlying accounting assumptions, and (2) more detailed information to assess the effects of useful lives assigned to long-lived assets.

Under the proposed rule, registrants would be required to provide beginning and ending balances and additions to and deductions from accounts established for each major class of valuation or loss accrual. Examples of accounts for which the disclosure would be required include allowances for doubtful trading accounts or notes receivable; allowances for sales returns, discounts and contractual allowances; unamortized discount or premium; excess of estimated costs over revenues on contracts (losses accrued under SFAS 5); liabilities for costs of discontinued operations; liabilities for exit and employee termination relating to a restructuring or business combination; contingent tax liabilities recorded under SFAS 5; product warranty liabilities, and probable losses from pending litigation. Disclosures provided in response to this item would not be audited, and would not be duplicated if they are presented in the financial statements.

Similarly, the proposed rule would require provision of unaudited information depicting beginning and ending balances and additions to and deductions from accounts established for each major long-lived asset classification and its corresponding accumulated depreciation, depletion and amortization account. Major long-lived asset classifications are those for which separate presentation is made on the balance sheet and include land, buildings, equipment, leaseholds, brand names, non-compete agreements, customer lists, and goodwill.

G. Disclosure of Equity Compensation Plan Information

As the use of equity compensation, particularly stock options, has increased in recent years, so too have concerns about the impact of these programs. These concerns involve (a) the absence of full disclosure to security holders about equity compensation plans, (b) the potential dilutive effect of these plans and (c) the adoption of many plans without the approval of security holders.

In Release No. 33-7944, dated January 26, 2001, the Commission proposed amendments that would require registrants to disclose, at least annually, information about the total number of securities that have been authorized for issuance under each equity compensation plan in effect as of the end of the last completed fiscal year, whether or not the plans have been approved by security holders. This disclosure would be set forth in a tabular format

- in the registrant's proxy statement whenever the registrant is seeking security holder action regarding a compensation plan; or
- in the registrant's annual report on Form 10-K in years when the

registrant is not seeking security holder action regarding a compensation plan.

These amendments would require disclosure in a registrant's proxy statement or annual report on Form 10-K or 10-KSB of the following information:

- the number of securities authorized for issuance under each equity compensation plan of the registrant in effect as of the end of the most recently completed fiscal year;

- the number of securities issued pursuant to equity awards made during the last completed fiscal year, plus the number of securities to be issued upon the exercise of options, warrants or rights granted during the last completed fiscal year, under each plan;

- the number of securities to be issued upon the exercise of outstanding options, warrants or rights under each plan; and

- other than securities to be issued upon the exercise of outstanding options, warrants or rights, the number of securities remaining available for future issuance under each plan.

This information would be provided without regard to whether the equity compensation plan was previously approved by a registrant's security holders. Registrants would be required to identify, either in the table or through a narrative statement, which of the equity compensation plans, if any, was adopted without security holder approval. They also would be required to provide a brief, narrative description of the material features of each plan adopted without security holder approval during the last completed fiscal year. The comment period on the proposed rule ended April 2, 2001.

H. Guarantors and Issuers of Guaranteed Securities

On August 24, 2000, the Commission adopted rules concerning the financial statements and Exchange Act reporting requirements for subsidiary guarantors and subsidiary issuers of guaranteed securities (Securities Act Release No. 7878). These rules include revisions to Rule 3-10 of Regulation S-X and new Rule 12h-5 under the Exchange Act. The rules supercede Staff Accounting Bulletin 53 (SAB 53).

The amendments to Rule 3-10 codify the staff's current positions as articulated in SAB 53 and the interpretive positions that the staff has taken with respect to SAB 53, with one principal difference. The rule does not permit the presentation of summarized financial information in lieu of separate financial statements of a subsidiary issuer or guarantor. Rather, it requires condensed consolidating financial information in all situations where SAB 53 permitted summarized financial information.

Amended Rule 3-10 retains the general requirement that each subsidiary issuer or guarantor must file the same financial statements specified by Regulation S-X for a registrant. It then identifies exceptions where more limited financial information is permitted. To qualify for an exception, the

guarantee must be full and unconditional, the subsidiary must be 100% owned by its parent company, the parent company must file consolidated financial statements meeting the requirements of Rules 3-01 and 3-02 of Regulation S-X, and the parent company's consolidated financial statements must include condensed consolidating financial information reflecting in separate columns the parent company, the subsidiary issuer (s), the subsidiary guarantors(s), any non-guarantor subsidiaries, consolidating adjustments, and the consolidated totals. This information is required in the registration statement and in the parent company's subsequent annual and quarterly reports under the Exchange Act. In certain limited cases, narrative disclosure about the guarantees is permitted in lieu of the condensed consolidating information. These limited circumstances include "plain vanilla" finance subsidiary issuers guaranteed solely by the parent company, and parent company issuers with no independent assets or operations where all direct and indirect subsidiaries included in the parent company's consolidated financial statements, other than minor subsidiaries, are guarantors. Narrative disclosure in lieu of condensed consolidating financial information is not permitted in circumstances where SAB 53 previously permitted summarized financial information, unless the conditions in the preceding sentence are met. The exceptions described above also apply to parent companies and subsidiaries that co-issue debt, provided that all other qualifying conditions are met.

Amended Rule 3-10 includes specific requirements applicable to recently acquired guarantors. If a significant recently acquired guarantor has not been included in the parent company's consolidation for at least nine months, one year of audited pre-acquisition financial statements of that guarantor is required in any registration statement for guaranteed securities. A recently acquired guarantor is significant if the greater of its pre-acquisition net book value or purchase price exceeds 20% of the principal amount of the securities being registered. Financial statements of recently acquired guarantors are not required in periodic reports under the Exchange Act.

New Rule 12h-5 exempts from Exchange Act reporting any subsidiary issuer or guarantor permitted by Rule 3-10 to omit financial statements. Thus Rule 12h-5 eliminates the need for subsidiary issuers or guarantors to request exemptive or no-action relief from Exchange Act reporting.

The rule revisions did not change the financial statement requirements for affiliates whose securities are pledged as collateral for a registered security, but those requirements have been relocated to new Rule 3-16 to distinguish them from the subsidiary issuer and guarantor requirements. Revisions to Item 310 of Regulation S-B clarify that the requirements of amended Rule 3-10 and Rule 3-16 apply to small business issuers. Appendices to the adopting release provide implementation guidance regarding the 100%-owned test, the identification of the parent company, and the financial statement requirements for recently acquired guarantors.

The rules became effective September 25, 2000. Registrants that have existing Exchange Act reporting obligations with respect to guaranteed securities must apply the new rules beginning with their annual report for their first fiscal year ending after September 25, 2000.

I. Recent Enforcement Actions Involving Financial Statements

1. Enforcement actions involving Sunbeam Corporation

On May 15, 2001, the Commission filed a civil injunctive action in U.S. District Court charging 5 former officers of Sunbeam Corporation and the former engagement partner on the Arthur Andersen LLP audits of Sunbeam's financial statements with fraud. The Commission also instituted settled administrative proceedings against Sunbeam and its former General Counsel, who, without admitting or denying the Commission's allegations, consented to the entry of cease-and-desist orders prohibiting future violations of specified provisions of the securities laws.

The Commission's complaint in the injunctive action alleges that senior management of Sunbeam, led by its CEO and CFO, engaged in a fraudulent scheme to create the illusion of a successful restructuring of Sunbeam and thus facilitate a sale of the Company at an inflated price. According to the complaint, the defendants employed a laundry list of fraudulent techniques, including creating "cookie jar" revenues, recording revenue on contingent sales, accelerating sales from later periods into the present quarter, and using improper bill and hold transactions. The complaint states that an engagement partner at Arthur Andersen, Sunbeam's outside auditing firm, authorized unqualified audit opinions on Sunbeam's 1996 and 1997 financial statements although he was aware of many of the Company's accounting improprieties and disclosure failures. For more information, see Accounting and Auditing Enforcement Release No. 1393.

2. Enforcement actions involving Waste Management, Inc.

On June 19, 2001, the Commission brought settled enforcement actions against Arthur Andersen LLP and four of its current or former partners in connection with Andersen's audits of the annual financial statements of Waste Management, Inc. for the years 1992 through 1996. Those financial statements, on which Andersen issued unqualified opinions, overstated Waste Management's pre-tax income by more than $1 billion. As alleged in the Commission's complaint and found in a related Commission order, Andersen knowingly or recklessly issued materially false and misleading audit reports on Waste Management's annual financial statements.

Andersen settled both a civil injunctive action charging violations of antifraud provisions of the federal securities laws, and related administrative proceedings finding that the firm had engaged in improper professional conduct. Without admitting or denying the allegations or findings, Andersen agreed to the first antifraud injunction in more than 20 years, and largest-ever civil penalty -- of $7 million -- in an SEC enforcement action against a Big Five accounting firm. Andersen further agreed to be censured under the SEC's rules of practice.

Three Andersen partners also settled both the civil injunctive action, which also charges them with violations of antifraud provisions of the federal securities laws, and related administrative proceedings. A fourth Andersen partner, a regional practice director, settled administrative proceedings finding that he had engaged in improper professional conduct. Without admitting or denying the allegations, the three partners each agreed to the entry of an antifraud injunction and to the payment of a civil penalty, and all four agreed to a bar from appearing or practicing before the Commission as an accountant for specified periods.

As alleged in the Commission's complaint or found in its related administrative order: In each of the years 1992 through 1996, the Andersen engagement team identified a variety of improper accounting practices. Andersen failed to quantify many of the non-GAAP accounting practices that it identified, and did not include them in its estimate of the effects of all known and likely misstatements identified by the audit. In connection with the audit of Waste Management's 1993 financial statements, Andersen proposed a series of "Action Steps" to change the practices only in future periods and to write off the company's prior misstatements over a five- to seven-year period, rather than require immediate correction. In many instances, the Company did not implement the Action Steps and continued to utilize accounting practices that did not conform with GAAP. In other cases, the Company offset misstatements and other expenses against gains while making no disclosure of the netting. Andersen told Waste Management that its use of netting was an "area of SEC exposure," but nonetheless allowed Waste Management to, in Andersen's own words, "bury" the charges. For more information, see Accounting and Auditing Enforcement Release No. 1405.

II. Other Current Accounting and Disclosure Issues

A. Disclosure, Accounting and Auditing Alerts

In a letter to Arleen Thomas of the AICPA, dated October 13, 2000, the Commission's Chief Accountant, Lynn Turner, identified a wide assortment of current disclosure, accounting and auditing issues that financial managers, auditors and audit committees should consider. Topics included in his letter that are addressed elsewhere in this outline include: revenue recognition and SAB 101; segment disclosures; FAS 133's accounting rules for derivatives and hedging; intangible assets; advertising costs; loan loss accounting and disclosure; auditor association with interim financial statements; and the equity method of accounting. Some other items addressed in Lynn Turner's letter are summarized below. Look to the letter itself for a more complete discussion of these issues (www.sec.gov/info/accountants/staffletters/audrsk2k.htm.

1. The expected impact of recently issued accounting standards should be disclosed, as discussed in SAB 74 (Topic 11:M). Disclosure should be considered with respect to any newly issued accounting guidance that comprises GAAP as specified by SAS 69.

2. Stock compensation accounting was modified by FIN 44. Reductions of an employee's stock option exercise price, either directly or indirectly, now subject the option to variable plan reporting from the date of the modification to the date of award, forfeiture or expiration. Also, registrants are reminded that awards of equity instruments to nonemployees should be valued realistically. If equity instruments are issued to customers at less than fair value, EITF 96-18 and 00-14 require companies to reduce product or service revenue in the amount of the discount in the same periods and manner as if a sales discount had been granted.

3. Convertible securities issued within one year of an IPO with beneficial conversion terms compared to the IPO price are presumed to result in additional compensation or other expense to the extent of the

difference between the IPO price and the conversion price. The registrant may rebut the presumption by presenting sufficient, objective, verifiable evidence supporting its fair value. The staff may request information about valuations that the underwriter discussed with senior management or the board of directors.

4. Income statement classification is very relevant to today's users of financial statements who are evaluating the quality of recurring revenues and expenses. The requirements of Regulation S-X should be observed. The EITF also provided recent guidance about classification: Issue Nos. 99-17 (barter), 99-19 (gross v. net), 00-10 (shipping & handling), 00-14 (coupons, rebates & discounts).

5. MD&A too frequently reports only the changes in historical reported amounts, without sufficient explanation of the reasons, or the necessary discussion of significant uncertainties and consideration of whether reported trends and financial relationships can be expected to continue. Some current developments that should be addressed, if applicable, are: foreign currency transactions; increasing fuel prices and interest rates; risks of exposures to highly leveraged entities; and financial reporting effects of employee pension and other post retirement plans caused by changes in the market value of plan assets or conversions to cash balance plans.

6. Accounting changes that must be retroactively implemented but are not material to prior period financial statements are addressed in SAB 5F. The cumulative effect of the change may be included in the income statement in the period that the change is made unless the cumulative effect is material to that period.

7. Changes in accounting estimates must be accompanied by the disclosures specified in paragraph 33 of APB 20. Robust discussion of the expected impact of the changes in estimate should also be included in MD&A.

8. Income tax shelters must meet the requirements of paragraph 33 of FAS 109 to justify non-recognition of the associated deferred tax liability. All disclosures required by paragraph 44 of FAS 109 should be provided.

9. International accounting and auditing issues that have been noted by the staff are: errors in the home-country GAAP financial statements disclosed only as items in the US GAAP reconciliation, rather than corrected in the primary financial statements; use of the cost method to account for subsidiaries and investees that are erroneously considered "immaterial;" failure to adjust an investee's local GAAP financial statements to the basis of accounting in the primary financial statements in applying the equity method; excessive time lags between the financial statements of the investor and investee in applying the equity method; failure to observe the US GAAP consolidation guidance found in EITF 96-16 and 97-2; failure to observe the significant influence criteria found in FIN 35; and failure to obtain Rule 3-09 financial statements and Rule 4-08(g) complete summarized data. Final rules on international disclosure standards have been adopted and can be found at www.sec.gov/rules/final/34-

41936.htm. All financial statements filed with the SEC are required to be audited in accordance with US GAAS , with an explicit statement of that fact in the auditor's report.

10. The Panel on Audit Effectiveness issued an extensive report and recommendations on August 31, 2000 (www.pobauditpanel.org). The SEC staff supports full implementation of the report's recommendations on a timely basis. Some key items highlighted in Lynn Turner's letter are the following:

    - The Panel on Audit Effectiveness recommends that audit committees devote additional attention to discussions of internal control with management and the independent auditors. The board should obtain a written report from management on the effectiveness of internal controls over financial reporting.

    - Auditors are required by ISB Standard No. 1 to disclose to the audit committee matters that could reasonably affect their independence. The staff encourages audit committees to consider ten factors in the final report of the Panel on Audit Effectiveness in assessing whether non-audit services provided by their independent auditors impair an auditor's independence or facilitate the performance of an audit, improve the company's financial reporting process, or are otherwise in the public interest. The Panel also recommends that audit committees pre-approve non-audit services that exceed a threshold determined by the audit committee.

11. Special advice for auditors also was included in Lynn Turner's letter:

    - Over one-half of the frauds analyzed in a recent report were the result of overstating revenue by recording revenue prematurely or fictitiously. End-of-period cut-off testing procedures should be designed carefully. The auditor's physical presence on location at the end of the period should be arranged. Audit procedures, including the direct confirmation with customers of material terms of significant contracts, should be adopted to aid in the detection of side agreements.

    - Nonstandard journal entries, especially those close to the end of the year, should be reviewed carefully and may require additional testing and substantiation.

    - Loss accruals and activity in accrued liability accounts should be carefully analyzed. Using the prior year's accrual as a basis for the current year is not appropriate. The need for and amount of loss accruals should be substantiated with current evidence each year.

    - Avoid over-reliance on management's representations as audit evidence.

    - Avoid over-reliance on internal controls, with insufficient

utilization of substantive procedures.

- o Read and compare other sections of documents containing audited financial statements as required by AU 550 to eliminate inconsistencies.
- o Prepare and maintain adequate working papers as required by AU 339.
- o Remember responsibilities under Section 10A of the Exchange Act of 1934 to report illegal acts to management and, in some cases, to the Commission in a timely manner.
- o Auditing firms with public company clients must have adequate quality control systems and procedures in place to ensure that they are in compliance with the independence rules of the SEC and the profession.

B. Segment Disclosure

FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*, became effective for fiscal years beginning after December 15, 1997. One significant focus of staff reviews currently is to evaluate whether registrants have complied completely with all the disclosure requirements of SFAS 131.

1. Identification of Segments

SFAS 131 defines an operating segment, in part, as a component of an enterprise whose operating results are regularly reviewed by the chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance. Segments may be aggregated in the disclosure only to the limited extent permitted by the standard. If segments are aggregated, that fact must be disclosed. Under SFAS 131, the chief operating decision maker is not necessarily a single person, but is a function that may be performed by several persons.

If the chief operating decision maker receives reports of a component's operating results on a quarterly or more frequent basis, the staff may challenge a registrant's determination that the component is not a segment for purposes of SFAS 131 unless reports of other overlapping sets of components are more clearly representative of the way the business is managed. On a few occasions, the staff has requested copies of all reports furnished to the chief operating decision maker if the reported segments did not appear realistic for management's assessment of a company's performance or conflicted with that officer's public statements describing the company. The staff also has reviewed analysts' reports, interviews by management with the press, and other public information to evaluate consistency with segment disclosures in the financial statements. Where that information revealed different or additional segments, amendment of the registrant's filings to comply with SFAS 131 was required.

2. Other Compliance Issues

Registrants should remember to identify the products and services from which each reportable segment derives its revenues, and to report the total revenues from external customers for each product or service or each group of similar products and services. Disclosures for products and services that are not substantially similar must be disaggregated. The staff has objected to overly broad views of what constitutes similar products. In its assessment of whether dissimilar products have been aggregated, the staff will review public disclosures and marketing materials that describe the registrant's products.

The reconciliation of segment elements to the consolidated financial statements should quantify and clearly explain each material reconciling item. Effects of measurement differences should be identified, and asymmetrical allocations among segments should be highlighted.

3. Changes in segments

The requirement to recast prior information to correspond with current reportable segments, or to otherwise provide comparable information, is discussed in paragraphs 34 and 35 of SFAS 131. Effects of changes in significance of reportable segments are discussed in paragraphs 22 and 23. If management changes the structure of its internal organization after fiscal year end, or intends to make a change, the new segment structure should not be presented in financial statements until operating results managed on the basis of that structure are reported.

C. Disclosures about Revenues

Registrants should review the completeness and accuracy of disclosures concerning their sources of revenues, method of accounting for revenues, and material considerations in evaluating the quality and uncertainties surrounding their revenue generating activity. The disclosure should be concise and to the point; more disclosure is not necessarily better. Basic descriptive information about revenue generating activities, customary contract terms and practices, and specific uncertainties inherent in the registrant's business activities may be most appropriate in Description of Business. Descriptive information about the effects of variations in revenue generating activities and practices, or changes in the magnitude of specific uncertainties, is most appropriate in MD&A. Accounting policies, material assumptions and estimates, and significant quantitative information about revenues should be included in notes to the financial statements. Some points to remember are the following:

Disaggregate product and service information

- Report product and service revenues (and costs of revenues) separately on the face of the income statement
- Furnish separate revenues of each major product or service within segment data
- Describe the major revenue-generating products or services clearly
- For major contracts or groups of similar contracts, disclose essential

terms, including payment terms and unusual provisions or conditions

Disclose <u>when</u> revenue is recognized (examples)

- Upon delivery (indicate whether terms are customarily FOB shipping point or FOB destination)
- Upon completion of service
- After commencement of service, ratably over service period
- Upon satisfaction of a significant condition of sale - (identify the condition)
    - Only after customer acceptance?
    - Only after testing?
- Upon completion of all terms of contract
- Over performance period based on progress toward completion
- Upon delivery of separate elements in multi-element arrangement

If revenue is recognized over the service period, based on progress toward completion, or based on separate contract elements or milestones, disclose <u>how</u> the period's revenue is measured

- Disclose how progress is measured (cost to cost, time and materials, units of delivery, units of work performed)
- Identify types of contract payment milestones, and explain how they relate to substantive performance and revenue recognition events
- Disclose whether contracts with a single counterparty are combined or bifurcated
- Identify contract elements permitting separate revenue recognition, and describe how they are distinguished
- Explain how contract revenue is allocated among elements
    - Relative fair value or residual method?
    - Fair value based on vendor specific evidence or by other means?

Disclose material assumptions, estimates and uncertainties

- Disclose contingencies such as rights of return, conditions of acceptance, warranties, price protection, etc.,

- Describe the accounting treatments for the contingencies
- Describe significant assumptions, material changes, and reasonably likely uncertainties
- Special disclosures and conditions are specified by SAB 101 for companies that recognize refundable revenues by analogy to SFAS No. 48, Sales With the Right of Return.

D. Issues Associated With SFAS 133, Accounting for Derivative Instruments and Hedging Activities

In June 1998, the FASB issued Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*). SFAS 133 establishes, for the first time, a comprehensive accounting and reporting standard for derivative instruments and hedging activities. This standard is applicable for all fiscal quarters of a registrant's first fiscal year beginning after June 15, 2000. One significant focus of staff reviews currently is to assure complete compliance with all the disclosure requirements of SFAS 133.

1. Formal Documentation Under Statement 133

One of the fundamental requirements of Statement 133 is that *formal* documentation be prepared at inception of a hedging relationship. The standard stresses the need for the documentation to be prepared contemporaneously with the designation of the hedging relationship. The formal documentation must identify the following:

- The entity's risk management objectives and strategies for undertaking the hedge;
- The nature of the hedged risk;
- The derivative hedging instrument;
- The hedged forecasted transaction; and
- A description of how the entity will assess hedge effectiveness.

Contemporaneous designation and documentation of a hedging relationship are fundamental to the application of hedge accounting. If contemporaneous documentation can not be demonstrated, an auditor will be unable to determine whether the company has, after the fact, selected the hedged item or transaction, or the method of measuring effectiveness, to achieve a desired accounting result. Accordingly, the staff will challenge the application of hedge accounting in instances where an entity has not contemporaneously complied with Statement 133's formal documentation requirements upon designation of a hedging relationship. Two documentation requirements are emphasized below.

The hedged forecasted transaction

Statement 133 stresses that the documentation of the hedged forecasted

transaction must be sufficiently specific such that when a transaction occurs, it is clear whether or not that particular transaction is the hedged transaction. Thus, the documentation of the forecasted transaction should include reference to the timing (i.e., the estimated date), the nature, and amount (i.e. the hedged quantity or amount) of the forecasted transaction.

Description of how the entity will assess hedge effectiveness

While Statement 133 provides an entity with flexibility in determining the method for assessing hedge effectiveness, the methodology used must be reasonable, and must be documented at inception of the hedging relationship. Additionally, Statement 133 requires that an entity use the chosen method consistently throughout the hedge period (a) to assess, at inception of the hedge and on an on-going basis, whether it expects the hedging relationship to be highly effective in achieving offset and (b) to determine the ineffective aspect of the hedge. The method used for assessing hedge effectiveness and measuring ineffectiveness must be documented with sufficient specificity so that a third party could perform the measurement based on the documentation and arrive at the same result as the registrant.

Financial statement presentation

The staff expects companies to continue the historical practice of including the results of hedging relationships on a net basis in the income statement line item associated with the hedged item. There is no required classification for the gain or loss recognized for hedge ineffectiveness or for any component of a derivative instrument's gain or loss that is excluded from the assessment of hedge effectiveness, but the amount of this net gain or loss and its income statement classification must be disclosed. Consistent classification should be observed in each period. Derivative assets and liabilities may be offset only to the extent permitted by FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts.* Although bifurcated for measurement purposes, embedded derivatives should be presented on a combined basis with the host contract.

2. Auditing Fair Values and SFAS 133

Management's assertions regarding fair values, timely hedge designation and documentation, and hedging effectiveness should be subject to on-going audit testing. Auditors should refer to SAS 92, ISB Interpretation 99-1, SAS 73, SAS 70, and 37 for guidance in this area. The AICPA has issued an Audit Guide, *Auditing Derivative Instruments, Hedging Activities and Investment Securities.*

3. Sale of Securities with Adoption of SFAS 133

The transition provisions contained in paragraph 54 of FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, provide that at the date of initial application, an entity may transfer any debt security classified as held-to-maturity pursuant to FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, into the available-for-sale category or the trading category and that such reclassification shall not call into question an entity's intent to hold other

debt securities to maturity in the future. The transition provisions further require that the unrealized holding gain or loss on a transferred held-to-maturity security be reported as part of the cumulative-effect-type adjustment of net income if transferred to the trading category or as part of the cumulative-effect-type adjustment of accumulated other comprehensive income if transferred to the available-for-sale category.

The staff believes that any security transferred from held-to-maturity pursuant to the adoption of Statement 133 and sold in the same reporting quarter should have been transferred to the trading category. Thus, any unrealized gain or loss on the security that exists on the date of transfer would be reported in net income as part of the cumulative effect of adopting Statement 133 and not included in the gain or loss on the sale of the security. This staff position is not intended to provide guidance as to the holding period for trading securities other than in this narrow situation involving the adoption of Statement 133.

Entities that adopt Statement 133 early in order to take advantage of the one-time reclassification of held-to-maturity securities are reminded that all of the provisions of Statement 133 must be applied upon such initial application. Piecemeal adoption of this Statement is not permitted. Consequently, the staff encourages entities to consider carefully all effects of implementing the Statement in forming a decision as to when to adopt the Statement. The staff expects to monitor closely the implementation of Statement 133.

4. Interim Period Disclosures

Registrants should consider the need for special disclosures in their Forms 10-Q arising from initial application of SFAS 133. Regulation S-X, Article 10-01(a)(5) requires disclosure in an interim period of new accounting principles and practices, details in accounts that have changed significantly in amounts or composition, and other significant changes that have occurred since the end of the most recently completed fiscal year. When a new standard is adopted in an interim period, the SEC staff has interpreted this requirement to mean that all disclosures prescribed by the new standard should be included in the interim financial statements, in addition to any transitional disclosures required by the new standard. Statement 133 is required to be adopted in fiscal years beginning after June 15, 2000. Its disclosure requirements are set forth in paragraphs 44 and 45, with enhanced disclosures for reporting changes in the components of comprehensive income in paragraphs 46 and 47, and transition disclosures in paragraph 53. The staff believes the disclosure requirements should be satisfied in the interim period in which the standard is adopted, as follows:

- Qualitative disclosures in paragraph 44. Disclosure is similar to what was required in Statement 119, modified for the updated rules on hedging. A registrant should enhance the Statement 119 disclosures provided previously to conform to paragraph 44 in the period of adoption.

- Quantitative disclosures in paragraph 45. Paragraph 45 disclosures are required for every reporting period for which a complete set of financial statements is presented (i.e. annual financial statements). In the interim period of adoption, we believe a registrant should

provide all paragraph 45 disclosures in order to inform the reader of the impact of adoption of the standard.

- Disclosure of changes in the components of comprehensive income. Paragraph 53 requires disclosure in the year of adoption of the amount of gains and losses that are being reclassified into earnings during the 12 months following the date of adoption, which were associated with the transition adjustment recorded to AOCI. Therefore, although the components of OCI are not required to be disclosed under Article 10 of Regulation S-X, the paragraph 46 and 47 disclosures should be made in the interim period of adoption in order for the paragraph 53 disclosure to be meaningful.

- Transition disclosures. Registrants should provide disclosure of transition amounts as well as disclosure of any reclassifications made upon adoption under paragraphs 54, 55 (both related to securities) or 56 (mortgage servicing rights).

- Disclosure in subsequent interim periods. The qualitative disclosure should be updated when a registrant significantly changes its objectives for holding or issuing derivative instruments and/or strategies for achieving those objectives. Registrants should consider the paragraph 45 disclosures when complying with the requirements of Item 303 of Regulation S-K and Rule 10-01(a)(5) of Regulation S-X. Paragraph 46 and 47 disclosures about the impact of hedging on OCI should be provided if material events occur.

E. Disclosures about Transfers and Servicing of Financial Assets

FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, changes the accounting for financial asset transfers and liability extinguishments that occur after March 31, 2001, while leaving the accounting for previous securitizations and extinguishments unaffected, except in certain circumstances. The standard also requires new disclosures about securitized financial assets and retained interests in securitized financial assets in financial statements for fiscal years ending after December 15, 2000. One significant focus of staff reviews during 2001 will be to assure complete compliance with all the disclosure requirements of SFAS 140.

Registrants should also consider the need for special disclosures arising from application of SFAS 140 in their Forms 10-Q for fiscal 2001. Regulation S-X, Article 10-01(a)(5) requires disclosure in an interim period of new accounting principles and practices, details in accounts that have changed significantly in amounts or composition, and other significant changes that have occurred since the end of the most recently completed fiscal year. When a new standard is adopted in an interim period, the SEC staff has interpreted this requirement to mean that all disclosures prescribed by the new standard should be included in the interim financial statements, in addition to any transitional disclosures required by the new standard. Statement 140 is required to be adopted in the interim period that includes April 1, 2001, and its disclosure requirements are set forth in paragraphs 17(a) through 17(g). The staff believes the disclosure requirements should be satisfied in the interim period in which the standard is adopted, as follows:

- Disclosures that mirror existing disclosure requirements: Paragraphs 17(b), (c), (d), (e) and (g)(2) were previously required by FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, and FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. If a registrant did not provide these disclosures in previously filed financial statements, it should provide these disclosures in the interim period in which Statement 140 is adopted.

- Disclosures for changes in accounting policy: Paragraphs 17(a)(1), (f)(1) and (g)(1) require disclosure of the entity's accounting policies. If adoption of the standard changes a registrant's accounting for securitized financial assets, or if a registrant did not include this disclosure in previously filed financial statements, it should provide the disclosures in the interim period in which Statement 140 is adopted.

- Transactions requiring disclosure: Paragraphs 17(a)(2), (a)(3), (f)(2), and (f)(3) require disclosures related to certain transactions. If a registrant enters into material transactions in an interim period after the adoption date of the standard, it should provide these disclosures.

- Other disclosures: The SEC staff recommends that registrants provide paragraph 17(f)(4) and (g)(4) disclosures in the interim period upon adoption. Also, in certain instances, these disclosures may be needed in the interim period in order for existing information not to be misleading, or may be necessary to satisfy the requirements of Item 303 of Regulation S-K. Paragraph 17(g)(3) disclosures should be considered by registrants to supplement their market risk disclosures (Item 305 of Regulation S-K) for sensitivity analysis, if material.

F. Market Risk Disclosures

Rule 3-05 of Regulation S-K prescribes disclosures about derivatives and market risks inherent in derivatives and other financial instruments. Under the rule, derivative financial instruments and other derivative financial instruments have the same meaning as those terms defined by GAAP. The requirements for quantitative and qualitative information about market risk apply to all registrants except registered investment companies and small business issuers.

In general, the rule:

(i) requires quantitative and qualitative disclosures about market risk inherent in derivatives and other financial instruments outside the financial statements; and

(ii) provides a reminder to registrants to supplement existing disclosures about financial instruments, commodity positions, firm commitments, and other forecasted transactions with related disclosures about derivatives.

Based on the Division's reviews of filings by some registrants required to provide the disclosures about derivatives and market risks inherent in derivatives and other financial instruments, we have the following

suggestions:

1. General

Remember to cite the new Item specifically (e.g. Item 7A for Form 10-K or Item 9A for Form 20-F) in the form. Registrants can include the quantitative and qualitative disclosures under the Item reference, cross-reference from the Item reference to the disclosures elsewhere in the filing, or indicate under the Item reference that the disclosures are not required (See Rule 12b-13).

Registrants must discuss material market risk exposures under the Item even though they do not invest in derivatives. For example, registrants that have embedded derivatives or investments in debt securities or that have issued long-term debt should discuss risk exposure if the impact of reasonably possible changes in interest rates would be material. Likewise, registrants that have invested or borrowed amounts in a currency different from their functional currency should discuss risk exposure if the impact of reasonably possible changes in exchange rates would be material.

The market risk disclosures can refer to the financial statements but disclosures required by the new rules should be furnished outside the financial statements. The "safe harbor" established under the new rules does not extend to information presented in the financial statements.

2. Sensitivity and Liquidity

In MD&A or in narrative explanations of market risk under Rule 305, management should consider what investors would think is important about the two key exposure dimensions common to all companies:

(a) Sensitivity: how derivatives alter the magnitude and even the direction of exposure relative to a "pure play" on the basic risk in the industry. Generally, sensitivity analysis provided pursuant to the market rules can address this, but stress testing over more than one range may provide critical information when options or discontinuous exposures exist. Whether or not quantitative sensitivity data is provided to investors, management's awareness of material sensitivities in reasonably likely scenarios should be shared with investors in MD&A or in narrative explanations of market risk.

(b) *Liquidity*: vulnerability of the company to survive large swings in risk factors, given the rights of counterparties to demand settlement before volatility returns to "normal" levels. Generally, value at risk information provided pursuant to the market risk rules can address this, but examination of how agreements with counterparties may operate in extreme conditions and other stress testing can reveal material vulnerabilities. Whether or not value at risk data is provided to investors, management's awareness of material vulnerabilities in reasonably likely scenarios should be shared with investors in MD&A or in narrative explanations of market risk.

3. Qualitative Disclosures

Explain clearly how the Company manages its primary market risk

exposures. Describe the objectives, general strategies and instruments used to manage each exposure. Explain clearly any changes in the strategies or tools used to manage exposures during the year in comparison to the prior year and disclose any known or expected changes in the future. Be specific in explanations of the intended result of the application of these policies (e.g., percentage of production intended to be hedged) and furnish any other information that would assist investors in understanding your particular position. To assure balance and usefulness, disclosures about commodity derivatives should be related to the company's exposures in the underlying commodity.

4. Quantitative Disclosures

Tabular Presentation. Include all relevant terms of the related market sensitive instruments. Annual cash flows associated with interest payments, as well as principal payments, should be evident from the presentation. In addition, disclose the method and assumptions used to determine estimated fair value, cash flows and future variable rates; segregate instruments by common characteristics and by risk classification.

Sensitivity Analysis and Value at Risk (VAR). Disclose the types of instruments (e.g., derivative financial instruments, other financial instruments, derivative commodity instruments) included in the sensitivity analysis and VAR analysis and provide an adequate description of the model and the significant assumptions used such as the magnitude and timing of selected hypothetical changes in market prices, method for determining discount rates, or key prepayment or reinvestment assumptions. Disclose any unusual features of your instruments that can affect the sensitivity of your exposure. Indicate whether other instruments are included voluntarily, such as commodity positions outside the required scope of the rule, cash flows from forecasted transactions, etc.

G. Other Than Temporary Declines in Value of Investment Securities

Temporary declines in the value of debt securities held-to-maturity are not recognized in earnings; temporary declines in value of available-for-sale debt and equity securities are netted with unrealized gains and reported as a net amount in a separate component of shareholders' equity. However, a decline in fair value below amortized cost that is other than temporary is accounted for as a realized loss. FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* specifies that "[i]f 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." This write down results in a new cost basis for the security, which cannot be recovered if the fair value subsequently increases.

Guidance in evaluating whether a security's recent decline in value is other than temporary is found in SAB 59, *Accounting for Noncurrent Marketable Equity Securities* (SAB 59). The SAB specifies that declines in the value of investments in marketable securities caused by general market conditions or by specific information pertaining to an industry or an individual company, "require further investigation by management." In this regard, SAB 59 states: "[a]cting upon the premise that a write-down may be required, management should consider all available evidence to evaluate

the realizable value of its investment." Therefore, in conducting its investigation, management should consider the possibility that each decline may be other than temporary and reach its determination only after consideration of all available evidence relating to the realizable value of the security.

As emphasized in SAB 59, other than temporary does not mean permanent. SAB 59 sets forth "... examples of the factors which, individually or in combination, indicate that a decline is other than temporary and that a write-down of the carrying value is required." These factors are (a) the length of the time and the extent to which the market value has been less than cost; (b) the financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer such as changes in technology that may impair the earnings potential of the investment or the discontinuance of a segment of the business that may affect the future earnings potential; or (c) the intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value.

In several Accounting and Auditing Enforcement Releases, *In the Matter of Fleet/Norstar,* AAER No. 29557; *In the Matter of Excel Bancorp, Inc.,* AAER No. 29675; *In the of Matter Abington Bancorp, Inc.,* AAER No. 30614; and *In the Matter of Presidential Life Corporation,* AAER No. 31934, the Commission has taken action in instances when other than temporary declines in value were not reported in a timely and appropriate fashion. In these releases, the Commission observed that a registrant's assessment of the realizable value of a marketable security should begin with its contemporaneous market price because that price reflects the market's most recent evaluation of the total mix of available information. Objective evidence is required to support a realizable value in excess of a contemporaneous market price. That information may include the issuer's financial performance (including such factors as earnings trends, dividend payments, asset quality, and specific events), the near term prospects of the issuer, the financial condition and prospects of the issuer's region and industry, and the registrant's investment intent.

Additionally, the releases state that the Commission expects registrants to employ a systematic methodology that includes documentation of the factors considered. The methodology should ensure that all available evidence concerning declines in market values below cost are identified and evaluated in a disciplined manner by responsible personnel. Auditors are reminded of the need to closely examine the documentation concerning their clients' determinations of other than temporary declines in market values.

H. Impact of SFAS 141 and 142 on Pro Forma Financial Statements

The pervasive effects of the new accounting standards on business combinations and purchased intangibles, and the unusual manner in which companies must transition to those standards, present special problems for pro forma financial statements that are required by Article 11 of Regulation S-X to depict the effects of recent or probable business combinations. For purposes of those presentations, the staff has provided the following guidance to registrants:

- Since a registrant's financial statements will continue to report goodwill amortization for any purchase business combination consummated prior to July 1, 2001 until the new SFAS 142 is adopted, and previous periods will not be restated to eliminate historical amortization, investors will be better informed if amortization on these acquisitions is not eliminated for purposes of pro forma information responsive to Article 11.

- Since registrants will never report goodwill amortization for acquisitions consummated on or after 7/1/01, Article 11 pro forma information should not depict amortization of goodwill for those acquisitions.

- Pro forma information responsive to Article 11 should not reflect any modification of the company's historical application of APB 16 to business combinations already reflected in the historical financial statements.

Separate from disclosures required by Article 11, registrants should furnish in MD&A or another appropriate location the disclosure discussed in SAB 74. That SAB identifies disclosures that a registrant should provide regarding the impact that recently issued accounting standards will have on its financial statements when the standard is adopted in a future period. Disclosures that should be considered include a brief description of the standard and its anticipated adoption date, the method by which the standard will be adopted, the impact that the standard will have on the financial statements to the extent reasonably estimable, and any other effects that are reasonably likely to occur.

Registrants should be aware also that paragraph 61 of SFAS 142 requires certain pro forma information in notes to financial statements until all periods presented reflect the accounting prescribed by the new standards. Pro forma financial information for the prior comparable period must be presented on a basis adjusted to reflect the effects on goodwill classification, non-amortization, and revised estimated useful lives under the new standard.

I. Valuing Equity Instruments

Many entities use valuation reports to determine the fair market value of equity instruments issued or received. The staff encourages companies to obtain independent valuations from competent professionals contemporaneous with the issuance of equity instruments. Concerns raised by the staff in its reviews of appraisals include:

- Failure to select, define, or conform to the standard of fair value appropriate to the valuation context and consistent with GAAP.

- Use of inappropriate public companies for comparables when selecting price-earnings multiples or volatility factors.

- Failure to adjust the registrant's or the comparable company's financial results for unusual or nonrecurring items.

- Reliance on undocumented or unsubstantiated "rules of thumb" (e.g., start-up companies that use a fixed percent of the most recent third-party preferred stock share price as a "rule of thumb" to value common stock or that applied general rules of thumb for lack of marketability and/or minority interest discounts/premiums in determining fair market value.)

- Failure to consider the counterparty's valuation, if known, and reconcile to that valuation.

- Internal inconsistencies (for example, increases in revenue growth without including significant investments required to realize the revenue growth).

The valuation of equity instruments should be based on sufficient, objective, verifiable evidence that is contemporaneously documented upon the issuance of the equity instruments and based on marketplace assumptions. The credibility of the fair value determination is strengthened by specific company evidence. Accordingly, a valuation generally should include, among other items:

- *Discussion of the company's performance, both historically and prospectively*. Any business valuation must begin with a thorough understanding of the company including, but not limited to, an understanding of the company's business, its products and services, strategies, markets, management team, and competitors.

- *Reconciliation of differences between the determination of the equity instruments' fair value and the IPO price*. These differences should also be documented and appropriately supported. For example, if such differences are the result of substantive changes in a company's underlying business and future prospects such as the introduction of a new product or the addition of a new customer, then that should be both quantified and discussed in the valuation document.

- *Discussion of valuations of the company performed by underwriters who have been approached with regards to an initial public offering*.

- *Discussion of transactions with independent third parties*. This type of evidence should be analyzed carefully to ensure that there is reasonable comparability between the nature of the third party equity transaction and the equity instruments subject to valuation. For example, if convertible preferred stock is being used as a proxy for valuing common stock, registrants should consider the preferred stock's terms, including, among other items, preferred stock liquidation preference. A liquidation preference may have little or no value if a company is in the process of registering its common stock and the preferred stock is mandatorily converted to common stock on a one-for-one basis at the IPO date. The staff believes that, in the absence of other differences in terms, and subject to the timing of the issuance, if the liquidation preference has little value and the conversion ratio is one-for-one, the common stock's value should approximate the convertible preferred stock's value.

Auditors are reminded that they should rigorously test the underlying valuation assumptions to external sources, if possible, and ensure those assumptions are reasonable.

J. Cross-Payments in Strategic Partnering Agreements

Strategic alliances, joint ventures and cross-licensing agreements are increasingly common. These arrangements often are complex and may involve promises by each party to transfer to the other cash, goods, services, and intellectual and property rights at different times over the term of the agreement. Because the elements of the agreement are negotiated as a package, it may be difficult to distinguish all the separate elements exchanged and reliably measure their fair values. In these circumstances, the company and the auditor should consider carefully whether cash flows, revenues and expenses associated with the arrangement can be meaningfully presented on a gross basis, or whether they must be presented on a net basis.

K. Allowance for Loan Losses

1. General considerations

The determination of the allowance for loans losses requires significant judgment. The balance in the allowance for loan losses should reflect management's best estimate of probable loan losses related to specifically identified loans as well as probable incurred loan losses in the remaining loan portfolio. FASB Statements 5 and 114 limit loss allowances to losses that have been incurred as of the balance sheet date. Accordingly, allowances for loan losses should be based on past events and current economic conditions. Disclosures that explain the allowance in terms of potential, possible, or future losses, rather than probable losses, suggest a lack of compliance with GAAP and are not appropriate.

The Commission provided guidance for registrants regarding the determination of loan loss allowances in FRR-28 (FRC 401.09.b.). Registrants must determine the amounts of their loan loss allowances in an appropriately systematic manner that demonstrates procedural discipline. That procedural discipline should include self-correcting policies that adjust loss estimation methods to reduce differences between estimated and actual observed losses. Procedural discipline means that a registrant should apply its methodology in the same manner regardless of whether the allowance is being determined at a higher point or a lower point in the economic cycle. The amount of the allowance reported in the financial statements should not differ materially from the amount determined using the methodology. Additional guidance is included in Staff Accounting Bulletin No. 102.

APB Opinion 22 sets forth the general requirements for accounting policy disclosures in the financial statements. Industry Guide 3 specifies additional detail that should be provided in explanation of loss allowances within the Description of Business. Viewed together, these disclosures should describe in a comprehensive and clear manner the registrant's accounting policies for determining the amount of the allowance in a level of detail sufficient to explain and describe the systematic analysis and procedural discipline applied. Registrants commonly develop different elements in their

allowances to estimate (1) losses based upon specific evaluations of known loss on individual loans, (2) estimated unidentified losses on various pools of loans and/or groups of graded loans, and (3) other elements of estimated probable losses based on other facts and circumstances. The disclosures should describe and quantify each element of the allowance, and explain briefly how the registrant's procedural discipline was applied in determining the amount, and not simply the "adequacy," of each specific element. If loans are grouped by pool or by grading within type to estimate unidentified probable losses, the basis for those groupings and the methods for determining loss factors to be applied to those groupings should be described. The basis for estimating the impact of environmental factors, such as local and national economic conditions and trends in delinquencies and losses, whether through modifying loss factors or through a separate allowance element, should be disclosed. Changes in methodology and their impact should be disclosed in accordance with APB Opinion #20.

MD&A should explain the period-to-period changes in specific elements of the allowance. It also should discuss the extent to which actual experience has differed from original estimates. The reasons for changes in management's estimates should indicate what evidence management relied upon to determine that the revised estimates were more appropriate and how those revised estimates were determined. A registrant following a procedural discipline should be recording provisions for loan losses that reflect the changes in asset quality as measured in the registrant's periodic loan reviews. MD&A should discuss the reasons for the changes in assets quality and explain how those changes have affected the allowance and provision. If historical loss experience appears low or high relative to the level of the allowance at the latest balance sheet date, a reconciling explanation should be provided. If a registrant changes its methodology, the basis for changing its methodology and the effects of the change should be explained.

2. Financial statement presentation

Allowances for credit losses are valuation accounts that should be presented as a reduction of the carrying value of the related balance sheet item. The allowance for loan losses should not include amounts provided for losses on financial instruments that are not classified on the balance sheet as loans. Amounts recognized for credit losses on certain off-balance-sheet financial instruments (e.g. forwards, and swaps) should be classified separately as liabilities.

Financial institutions must present the provision for loan losses as a deduction in the determination of net interest income, pursuant to Article 9 of Regulation S-X. Credit loss provisions on other types of balance sheet and off-balance sheet items that do not affect net interest income should not be included in the provision for loan losses. Loss provisions not related to interest income should be recorded in other appropriate categories of income or expense. Direct transfers of amounts between the allowance for loan losses and other credit loss allowances are not appropriate. Changes in the amount of the allowance for loan losses should be reflected in the provision for loan losses, while changes in other allowances should be reflected in other appropriate categories of income or expense.

L. Loan Splitting and Similar Restructurings

The Emerging Issues Task Force has considered the accounting for a loan that is restructured in a troubled debt restructuring into two or more separate loan agreements. See EITF Issue No. 96-22, "Applicability of the Disclosures Required by FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan, When a Loan is Restructured in a Troubled Debt Restructuring into Two (or More) Loans." The EITF concluded that the restructured loans should be considered separately when assessing the applicability of disclosures required by paragraphs 20(a) and 20(c) of Statement No. 114 in the periods after the restructuring because they are legally distinct from the original loan. The Task Force noted further that the creditor was required by Statement No. 114 to continue to base its measurement of loan impairment on the contractual terms specified by the original loan agreement.

The SEC Observer at the EITF furnished additional guidance for public companies regarding loans addressed by Issue No. 96-22. Registrants that restructure loans into multiple loans should provide a qualitative discussion about the impact of the restructurings on the impaired loan disclosures. That discussion should include the reasons for renegotiating the loans into multiple loan structures and the extent to which the renegotiated loans affect trends in the impaired loan disclosures. If impaired loans are restructured into multiple loans through troubled debt restructurings, or through another type of restructuring (such as splitting or re-documenting a loan without granting concessions), resulting in an improvement to the quality of the loan portfolio, registrants should present clearly the resulting impact of the multiple loan structures on the loan portfolio and the allowance for loan losses. This discussion could include the following:

- the aggregate balance of restructured loans as of the end of each reported period;
- the aggregate volume of the restructuring activity during each reported period (if different than the aggregate ending balance of restructured loans);
- the general nature of concessions on restructured loans (as applicable);
- the reasons for renegotiating loans into multiple loan structures, if applicable;
- the impact, during each reported period, of loan restructurings on trends in the past-due, non-accrual, and impaired loan disclosures;
- the impact, during each reported period, of loan restructurings on the allowance for loan losses; and
- the impact, during each reported period, of loan restructurings on current period earnings.

M. Effective Date of a Business Combination

Paragraph 93 of APB 16 generally requires that a company record an acquisition as of the date consideration is exchanged for the business.

Designation of a different date for convenience purposes is permitted in limited circumstances. However, "the designated date should ordinarily be the date of acquisition for accounting purposes if a written agreement provides that effective control of the acquired company is transferred to the acquiring corporation on that date without restrictions except those required to protect the stockholders or other owners of the acquired company - for example, restrictions on significant changes in the operations, permission to pay dividends equal to those regularly paid before the effective date, and the like."

The staff will challenge designation of a date different than the date consideration is exchanged for the business if the acquisition is accounted for as if it took place more than one fiscal quarter before or after the date the transaction is consummated. The flexibility permitted by paragraph 93 recognizes the difficulty of completing a closing of financial books on a date other than at a month or quarter's end. Acceleration or delay of recognizing the effects of a business combination beyond a short period required for practical reasons must be supported by written contracts and other persuasive evidence that clearly correlates the designated date with the transfer of effective control.

N. Cost or Equity Method of Accounting

An investment must be accounted for using the equity method if the investor has significant influence over the investee's operating and financial policies. Significant influence is presumed to exist where the investor owns 20-50% of the investee's voting stock. In some circumstances, that presumption is overcome by predominant evidence to the contrary. FASB Interpretation No. 35 sets forth indicators, which are not all-inclusive, that an investor may be unable to exercise significant influence. Disclosure must be made if the registrant accounts for an investment differently than would be presumed for the voting interest held.

In a recent case, the staff disagreed with a registrant that believed the presumption of significant influence was overcome. Despite holdings exceeding 20% of the voting stock of certain investees, the registrant accounted for the investments at cost (or as marketable securities under FASB Statement No. 115). The registrant argued that it had not influenced the investees, and did not intend to do so. However, since the accounting depends on the *ability* of the investor to influence the investee, the staff believed revision of the financial statements was necessary.

In another circumstance, the staff questioned a registrant's use of the cost method even though it held less than 20% of an investee, because other facts indicated that significant influence existed. In this case, the staff believed the equity method was necessary where a registrant held only 19% of the voting stock but was entitled to select more than 20% of the investee's board of directors.

FASB Interpretation No. 35 requires an investor to evaluate all facts and circumstances relating to the investment when any of the identified or similar circumstances exist, in order to reach a judgment about whether presumptions concerning the ability or inability to significantly influence the investee should be overcome. In addition to factors identified by FIN 35, the staff considers the nature, form and significance to the investee of all of

the investor's financial and operating interest in the investee, the protective and participating rights of the investor and other investors, and whether the investor's participation in the board is disproportionate to its common stock voting interest.

O. Disclosures about Intangible Assets

Wide variations between a company's stock price and its underlying book value per share frequently are attributed to the failure of the current accounting model to recognize a company's internally generated intangibles. Despite the importance that investors evidently place on those intangibles, a FASB Business Reporting Project Steering Committee observed that its review of filings by public companies indicated a "general lack of meaningful and useful disclosures about intangible assets."

Presently, intangible assets are accounted for differently than tangible assets primarily because of the high uncertainty regarding the future outcomes and current fair market values of intangibles. While better accounting models continue to be pursued, Baruch Lev, Professor of Accounting and Finance at New York University, offers good advice to registrants about what they can do now:

> The distinction between the *measurement* issues concerning intangibles and the *disclosure* of substantive information about intangibles is often lost in public debate. The difficulties in valuing intangibles should not preclude the disclosure of factual, important information about the characteristics of intangibles. [emphasis added]

Registrants should consider the need for more extensive narrative and quantitative information about the intangibles that are important to their business. These disclosures often are appropriate in *Description of Business* or *Management's Discussion & Analysis*. Some disclosures required by GAAP or Commission rules provide useful information to investors about intangibles, such as amounts annually expended for advertising and research & development. More insight could be provided if management elected to disaggregate those disclosed amounts by project or purpose. Statistics about workforce composition and turnover could highlight the condition of that human resource intangible. Disclosure of annual expenditures relating to training and new technologies could help investors distinguish one company's intangibles from another. More specific information about patents, copyrights and licenses, including their duration, royalties, and competitive risks can be important to investors. Insight into the intangible value of management talent could be provided by supplementing financial information with performance measures used to assess management's effectiveness.

P. Accounting for Customer Relationship Intangibles

Some intangible assets recognized in a purchase business combination derive their value from future cash flows expected to be derived from the acquired business' identified customers. Companies may also recognize this type of intangible asset when they acquire groups of customer accounts or a customer list. Most commonly, valuable continuing relationships are

demonstrated by existing contracts or subscriptions.

When acquired in a business combination or as part of a larger group of assets, the fair value of this intangible is often measured as the present value of the estimated net cash flows from the contracts, including expected renewals. The most reliable indication of life expectancy of a subscriber base or similar customer group is the historical life experience of similar customer accounts. The actuarial-based retirement rate method is the method generally accepted in the appraisal profession to estimate life expectancy. That analysis may be developed if customer initiation and termination data are maintained for each acquired customer group.

Customer relationship assets must be amortized systematically to allocate the capitalized amount over the periods expected to be benefited. Management must evaluate at each balance sheet date whether the actual net cash flows from the acquired customers accounts have been or are likely to become different from those underlying the method of allocating the asset's cost. The applicable accounting literature for recognition of the intangible asset, its amortization, and changes in estimates underlying its amortization is found in APB 17, APB 20, and FAS 121.

Typically, customer relationships within a large group of accounts tend to dissipate at a more rapid rate in the earlier periods following a company's succession to the contracts, with the rate of attrition declining over time until relatively few customers remain who persist for an extended period. Under this pattern, the preponderance of cash flows derived from the acquired customer base will be recognized in income in the earlier periods, and they fall to a materially reduced level in later years. In this circumstance, straight-line cost amortization over the period of expected cash flows particularly will exaggerate net earnings when the business is growing, leaving disproportionate expense to be recognized when the rate of growth declines. The staff believes that an accelerated method of amortization, rather than the straight-line method, will result in the most appropriate and systematic allocation of the intangible's cost to the periods benefited. The straight-line method is appropriate only if the estimated life of the intangible asset is shortened to assure that recognition of the cost of the revenues, represented by amortization of the intangible asset, better corresponds with the distribution of expected revenues.

Some registrants failed to recognize the financial reporting effects of customer attrition at levels greater than assumed when they initially selected the amortization method and period. These companies maintained and reported only aggregate attrition statistics that combined all past and current acquisitions of customer accounts. Statistics reported in that manner can hide unfavorable customer attrition occurring within particular acquired customer groups, and can delay the recognition of broader unfavorable trends. A customer attrition rate that is actually static or increasing can appear to be declining if calculated on a base of customers that is rapidly increasing through new acquisitions.

The staff believes that registrants must maintain records and controls necessary to compare actual and estimated attrition for each material acquired customer group throughout its economic life, and must revise accounting estimates on a timely basis when adverse trends develop. A registrant that makes frequent and continuing purchases of blocks of

customers may aggregate different acquisitions occurring within a fiscal quarter and periodically evaluate life expectancy of that grouping, rather than individually, if the customer blocks combined in the quarter are reasonably expected to behave in a similar manner over time.

The complete range of assumptions affecting the life expectancy and related cash flows from customer relationship assets should be tested regularly for continuing relevance. For example, original assumptions regarding pricing or the frequency and pattern of payments may differ from subsequent experience and require revision of the cost amortization. Registrants must also consider the requirements of FAS 121, which prescribes when a long-lived asset must be assessed for impairment such that a write-down to current market value becomes necessary.

Q. Accounting for Sales Commissions Paid

Generally, sales commissions should be charged to income when the registrant incurs a liability to pay them. If revenue on the transaction for which the sales commission was earned is deferred under GAAP, the commission may be deferred to the extent of the deferred revenue, and then amortized into expense in proportion to the revenue recognized each period. The staff believes that commissions paid in connection with a service contract should be deferred and amortized over a period not exceeding the noncancellable term of the contract.

Commissions advanced to sales agents should be accounted for as receivables if the registrant is legally entitled to recover the advances and generally will enforce that right if the advances are not earned. In this case, commission advances reported on the balance sheet are financial instruments, and disclosure of their fair value, if materially different from their carrying value, is necessary pursuant to SFAS 107.

Some commissions characterized as advances should be accounted for as earned commissions. For example, commissions paid by a registrant on new sales of annual service contracts originally amounted to approximately 75% of the contract value. The program was changed to a commission of approximately 25% of the contract value plus an advance equal to commissions on two annual renewals, each at approximately 25% of the contract value. Although some contracts were not renewed as anticipated by the advances, the registrant never sought recovery of any unearned advances. The new program did not change the timing, amount or tax treatment of the cash payments. In this circumstance, the staff believed that the change to the new commission system had no substance, objected to characterization of any amount of the commission as an "advance receivable" on the balance sheet, and advised the registrant that the entire amount paid to the sales agent at contract signing should be expensed immediately.

R. Research and Development Activities - Accounting and Disclosure

Biotechnology companies and others engaged in research and development activities often provide services and transfer rights under complex arrangements that present many accounting and disclosure issues. The arrangements may include payment terms that include receipt of up-front fees and milestone payments. These arrangements may include multiple

elements such as product licensing agreements, manufacturing/supply agreements, royalty agreements, research and development agreements, and equity issuances, among others. Different methods of accounting for revenue and expense recognition may be appropriate under each of these arrangements. If these arrangements comprise a significant portion of revenues, clear and balanced disclosure should be provided about the terms of the arrangements, the methods of accounting for them, the specific risks and uncertainties associated with them, and their historical and expected effects on operations and financial position.

1. Revenue Recognition

Question 5 to SAB 101 advises that up-front fees, such as technology license fees, should be deferred and recorded over the term of the agreement unless it is clear that the earnings process is completed. In evaluating whether the earnings process is complete, the perspective of the licensee must be considered. If the licensee requires from the registrant future products or services to exploit the license, the license fee ordinarily should be deferred because the earnings process is not complete.

Many arrangements provide for milestone payments to be received either based on the passage of time or the occurrence of specific events. The timing of milestone payments may be reflective simply of project financing terms, rather than representative of the culmination of any particular earnings process. Diversity in accounting for milestone payments exists. In some cases, registrants defer milestone payments and recognize contract revenue on a systematic basis corresponding with services, costs, or time. In other cases, registrants recognize milestone payments as earned upon the occurrence of contract-specified events, if those events coincide with the achievement of a substantive element in a multi-element arrangement or measure substantive stages of progress toward completion under a long-term contract.

To make the arrangements transparent to investors, the following disclosures are encouraged:

(a) *Business Discussion* - Describe each type of arrangement entered into by the company, explaining its business purposes and the underlying activities. Examples of agreement types are product/technology licenses, research and development agreements, production/supply agreements, royalty agreements, equity sales agreements, etc. Disclose the significant terms and characteristics of material agreements, including the various elements of products and services to be delivered by each party, the contract period, payment terms and amounts, obligations of the parties, events and circumstances that trigger milestone payments, and termination provisions. If the company has more than one arrangement with the same party, or that party has other types of relationships with the company, such as vendor, customer, or stockholder, discussion of the multiple relationships and arrangements together may be necessary for investor understanding.

(b) *Management's Discussion and Analysis* - Discuss the historical and expected effects of material new contracts and the achievement of revenue recognition milestones on operations and financial position. Disclose the amounts of material up-front and milestone fees scheduled to be received

and to be recognized as revenue over each of the next five years. Material uncertainties affecting realization of fees should be highlighted.

(c) *Financial Statements* - Disclose your revenue recognition policies. Describe specifically how you apply your policies for each major revenue stream (i.e., research and development services, license agreements, product sales, consulting) and payment form (i.e., up-front fees, milestone fees, royalty payments). If different revenue recognition policies are followed for a particular major revenue stream or payment form due to varying facts, circumstances or contractual terms, each policy should be separately described. In many cases, especially for recognition of milestone payments, it will be necessary to discuss the facts and circumstances resulting in the culmination of the earnings process. Disclose your accounting policies for multi-element arrangements. Disclose the major terms of material arrangements/agreements.

2. Research and Development Expenses

Many biotechnology registrants incur significant research and development expenses. Although these expenditures may represent the majority of the expenses for many of these registrants, the discussion of R&D expense in Commission filings is generally uninformative. As indicated in FRC 501.01, MD&A is intended to give an investor an opportunity to view a registrant through the eyes of its management. The following disclosures are encouraged to enhance an investor's understanding of the company's use and expected use of resources in R&D activities:

(a) *Business Discussion* - Disclose the nature and status of each major R&D project or group of related projects currently in process.

(b) *Management's Discussion and Analysis* - Disclose for major R&D projects or groups of related projects the costs incurred to date, the current status, and the estimated completion dates, completion costs and capital requirements. If estimated completion dates and costs are not reasonably certain, discuss those uncertainties. Disclose the risks and uncertainties associated with completing development projects on schedule and the consequences if they are not completed timely.

(c) *Financial Statements* - Disclose your accounting policies for internal research and development expenditures, research and development conducted for others, and research and development services for which you have contracted. Disclose the types of costs included in R&D costs, including salaries, contractor fees, building costs, utilities, administrative expenses and allocations of corporate costs. Disclose the amount of research and development expenses incurred in each year.

S. Auditor Association with Interim Financial Statements

Rule 10-01(d) of Regulation S-X and Rule 310(b) of Regulation S-B require the review of interim financial statements by an independent public accountant prior to their filing in Forms 10-Q or 10-QSB. The registrant is not required to state in the filing that the interim financial statements have been reviewed. A report of the independent public accountant is required to be included in the filing only if the registrant states that the financial

statements have been reviewed. The interim review should be conducted in accordance with SAS 71. The AICPA's Professional Issues Task Force issued Practice Alert No. 2000-4, which provides auditors with important information they will need to consider for quarterly reviews of financial statements of public companies.

If the registrant fails to obtain a review of the interim financial statements prior to their filing in Forms 10-Q or 10-QSB, the filing is deficient and the registrant is deemed not to be current or timely in its Exchange Act filings. If a review was not obtained, the staff believes the registrant should disclose prominently, *preferably under Item 1 of Part I and preceding the quarterly financial statements*, that it did not obtain a review of the interim financial statements by an independent accountant using professional review standards and procedures, although that review is required by the form. Completion of a review after the interim financial statements have been filed with the Commission will make the filing current, although it will not be deemed timely.

Auditors have professional responsibilities to consider when the registrant files interim financial statements in a Form 10-Q or Form 10-QSB that have not been reviewed. Unless otherwise disclosed in the filing, investors are likely to presume that the review required by the form has been performed by the auditor of record. If financial statements with which the independent accountant would be associated are included in a Form 10-Q or Form10-QSB without the accountant's timely review, the auditor should consider Practice Alert 2000-4, AU§504 and Exchange Act Section 10A. Practice Alert 2000-4 advises that the auditor should consider discussing that failure with the company's audit committee and the company's legal counsel. If the deficiency is not immediately addressed through the accountant's completion of a review, the accountant should request that the client promptly amend the filing to disclose that the financial statements have not been reviewed by an independent accountant as required by the form. In addition, the auditor has a responsibility to follow the guidance in Section 10A. Under that section, if the company and its board fail to take appropriate remedial action with respect to an illegal act that is material to the financial statements, and the auditor reasonably expects to modify its report or resign due to the illegal act, then the auditor should report the violation of the law to the SEC.

T. Effects of Changes to Financial Statements Filed with the Commission in an IPO

In some cases, as a result of a *correction of an error* within the scope of paragraph 36 of APB 20 or *retroactive adjustment of an accounting principle* under the special provisions of paragraph 29, financial statements previously furnished with an accompanying audit report to security holders who were not promoters or related parties are changed for use in an initial registration statement, or financial statements included in a filing with the Commission are changed in subsequent amendment or other filing. In each of these cases, disclosure must be made in the financial statements pursuant to paragraphs 37 and 30, respectively, of APB 20, and Rule 3-03 (c) of Regulation S-X. We believe the change should also be referenced in the auditor's report, as indicated by AICPA Auditing Standards Section 561.06.a., with dual dating of the audit report necessary in some circumstances. Financial statements and an audit report emphasizing the

restatement should be distributed to those persons who received previously the incorrect financial statements, with a scope of distribution substantially similar to that originally used. For example, if the financial statements used in a "red herring" prospectus circulated to investors are subsequently changed for correction of an error, we believe financial statements and audit report highlighting and explaining the restatement must appear in the final prospectus, or in a prospectus that is recirculated prior to the final prospectus. In any case, we believe it is the responsibility of management to disclose to current users of a prospectus how the financial statements are different from those previously considered by the investors or from those which the registrant used to raise capital from earlier investors.

III. Other Information About the Division of Corporation Finance and Other Commission Offices and Divisions

A. Other Sources of Information

Much information about the Commission, proposed and recently adopted rules, and other activities and developments may be found at the Commission's website -- http://www.sec.gov. Information about current issues and interpretations in the Division of Corporation Finance can be found at www.sec.gov/divisions/corpfin.shtml. Information of particular interest to accountants practicing before the Commission is located at www.sec.gov/info/accountants.shtml. Other documents that may be of particular interest to readers of this outline include:

- *Frequently Requested Accounting and Financial Reporting Interpretations and Guidance* -- www.sec.gov/divisions/corpfin/guidance/cfactfaq.htm

- *Frequently Requested Interpretations of Rules for Business Combinations Accounted for as Pooling-of-Interests* -- www.sec.gov/divisions/corpfin/guidance/cfbcafaq.htm

- International Financial Reporting and Disclosure Issues in the Division of Corporation Finance -- http://www.sec.gov/divisions/corpfin/internatl/issues0501.htm

B. Corporation Finance Staffing and Phone Numbers

The Division's organizational structure follows:

Division Director - David B.H. Martin (202) 942-2800

Deputy Director - Michael McAlevey (202) 942-2810

Operations

Principal Associate Director (Disclosure Operations) - Shelly Parratt (202) 942-2830

Associate Directors (Disclosure Operations) - James Daly (202) 942-2881

Associate Directors (Disclosure Operations) - William L. Tolbert, Jr. (202) 942-2891

Disclosure Support and Other Offices

Associate Director (Legal) - Martin P. Dunn (202) 942-2890

Associate Director (Regulatory Policy) - Mauri Osheroff (202) 942-2840

Senior Counsel to the Director - Anita Klein (202) 942-2980

Senior Special Counsel (Regulatory Policy) - James Budge (202) 942-2800

Office of Chief Counsel - Paula Dubberly, Chief (202) 942-2900

Office of Mergers and Acquisitions - Dennis O. Garris, Chief (202) 942-2920

Office of International Corporate Finance - Paul Dudek, Chief (202) 942-2990

Office of Rulemaking - Elizabeth Murphy, Chief (202) 942-2910

Office of Small Business Policy - Richard Wulff, Chief (202) 942-2950

Office of EDGAR and Information Analysis - Herbert Scholl, Chief (202) 942-2930

Office of the Chief Accountant [fax (202) 942-9582]

Associate Director (Chief Accountant) - Robert Bayless (202) 942-2850

Craig Olinger, Deputy Chief Accountant (202) 942-2850

Liaison to: Foreign Private Issuers

Todd Hardiman, Associate Chief Accountant (202) 942-2960

Liaison to: Office # 1 (Healthcare and Insurance)

Office # 3 (Computers and Office Equipment)

Office # 9 (Small Business)

Joel Levine, Associate Chief Accountant (202) 942-2960

Liaison to: Office # 2 (Consumer Related Products)

Office # 8 (Real Estate and Business Services)

Office # 10 (Electronics and Machinery)

Leslie Overton, Associate Chief Accountant (202) 942-2960

Liaison to: Office # 4 (Natural Resources and Food)

Office # 6 (Manufacturing and Construction)

Office # 11 (Telecommunications)

Carol Stacey, Associate Chief Accountant (202) 942-2960

Liaison to: Office # 5 (Transportation & Leisure)

Office # 7 (Financial Services)

Assistant Directors (AD) and Senior Assistant Chief Accountants (SACA)

#1 Health Care and Insurance - AD - Jeffrey Reidler (202) 942-1840

SACA - Jim Rosenberg (202) 942-1803

#2 Consumer Products - AD - H. Christopher Owings (202) 942-1900

SACA - Jim Allegretto (202) 942-1885

#3 Computers and Office Equipment - AD - Barbara Jacobs (202) 942-1800

SACA - Dennis Muse (202) 942-1862

#4 Natural Resources and Food - AD - Roger Schwall (202) 942-1870

SACA - Barry Stem (202) 942-1919

#5 Transportation and Leisure - AD - Max Webb (202) 942-1850

SACA - Joseph Foti (202) 942-1952

#6 Manufacturing and Construction - AD - Steven Duvall (202) 942-1950

SACA - John Hartz (202) 942-1798

#7 Financial Services - AD - Todd Schiffman (202) 942-1760

SACA - Don Walker (202) 942-1799

#8 Real Estate and Business Services - AD - Karen Garnett (202) 942-1960

SACA - Linda Van Doorn (202) 942-1964

#9 Small Businesses - AD - John Reynolds (202) 942-2999

SACA - Tia Jenkins (202) 942-1902

#10 Electronics and Machinery - AD - Peggy Fisher (202) 942-1880

SACA - Margery Reich (202) 942-1839

#11 Telecommunications - AD - Barry Summer (202) 942-1990

SACA - Carlos Pacho (202) 942-1876

C. Division Employment Opportunities for Accountants

For more information about any of the positions or programs described below, contact Carol Stacey, Associate Chief Accountant, at (202) 942-2960, or fax your resume to (202) 942-9582. You can also visit our website at www.sec.gov/jobs.shtml - acct for current information about employment opportunities in the Division.

1. Staff Accountant

The Division provides a fast-paced, challenging work environment for accounting professionals. Our staff reviews the accounting and disclosure for hot IPOs, novel transactions and securities, and complex mergers and acquisitions. We analyze current and emerging accounting issues, interact with the top professionals in the securities industry, and influence

accounting standards and practices around the world. A Staff Accountant's responsibilities include examining financial statements in public filings and finding solutions to the most difficult and controversial accounting issues.

A minimum of 3 years' experience in a public accounting firm or public company dealing with SEC reporting is required. The staff accounting position offers a unique learning experience and the opportunity to explore the full depth and breadth of accounting theory, principles, and practices. Salary to low $90k, based on experience and current salary.

2. Professional Accounting Fellowships

The Division also has openings for up to ten positions for Professional Accounting Fellows for a nonrenewable term of two years. This program provides Accounting Fellows with in-depth exposure to the Commission's full disclosure system administered by the Division. Accounting Fellows, working in a team with other staff accountants and lawyers, review filings by public companies to identify material accounting, auditing or financial reporting deficiencies resulting from deviations from GAAP, GAAS, and SEC rules and regulations.

To be eligible for participation in the program, a successful candidate must have three to nine years of auditing experience in a public accounting firm, must be familiar with SEC reporting requirements, and must be a Certified Public Accountant. Candidates will be evaluated on the basis of their qualifications. Salary to low $90k, based on experience and current salary.

3. Professional Academic Fellowships

The Division established its academic fellowship program in 1998. Under this program, an accounting professor can use a sabbatical year or leave of absence to become involved directly in top-level, contemporary accounting and auditing issues as they arise in the Division's oversight of filings by public companies. The fellowship involves reviewing filings by public companies to identify significant accounting and disclosure problems, researching financial reporting issues in connection with Division policy or program initiatives, and developing and presenting training on emerging or controversial accounting issues for accountants and attorneys in the Division. Requirements include a Master's or PhD, and extensive teaching experience in upper-level/advanced financial accounting courses.

For faculty members at U.S. universities, the academic fellow position is available under the Intergovernmental Personnel Act (IPA), and generally involves a 12-month (August to August) contract among the SEC, the professor, and the professor's university. Under the contract, the professor continues to be an employee of the university, while the SEC reimburses the university for 12/9's of the professor's academic year salary, up to approximately $117,000 (equivalent to the pay grade GS 15/10). The employing university may elect to pay the professor more than the reimbursement cap. According to industry sources, an SEC fellowship is viewed very favorably at institutions where sabbaticals are awarded competitively.
http://www.sec.gov/divisions/corpfin/acctdisc.htm