SEC Regulations Committee Highlights

Joint Meeting with SEC Staff - July 9, 1998

Location: SEC Headquarters – Washington, D.C.

NOTICE: The AICPA SEC Regulations Committee meets periodically with the staff of the SEC to discuss emerging technical accounting and reporting issues relating to SEC rules and regulations. The purpose of the following highlights is to summarize the issues discussed at the meetings. These highlights have not been considered and acted on by senior technical committees of the AICPA, or by the Financial Accounting Standards Board, and do not represent an official position of either organization.

In addition, these highlights are not authoritative positions or interpretations issued by the SEC or its staff. The highlights were not transcribed by the SEC and have not been considered or acted upon by the SEC or its staff. Accordingly, these highlights do not constitute an official statement of the views of the Commission or of the staff of the Commission.

I. **ATTENDANCE**

A. **SEC Regulations Committee**

Robert H. Herz, Chairman
Ernie Baugh
Rusty Brinkman
Ed Coulson
David Einhorn
Wendy Hambleton
Jay Hartig
Terri Iannaconi
Rodney Liddle
Eric Press
Tony Ressino
Amy Ripepi
Stewart Sandman
Bill Travis
Bill Yeates

B. **Securities and Exchange Commission**

Office of the Chief Accountant

Lynn Turner, Chief Accountant
Jane Adams, Deputy Chief Accountant
Jack Albert, Associate Chief Accountant
Scott Bayless, Associate Chief Accountant
Robert Burns, Chief Counsel
Eric Casey, Professional Accounting Fellow
Pascal Desroches, Professional Accounting Fellow
D.J. Gannon, Professional Accounting Fellow
Jeffrey Jones, Professional Accounting Fellow

Paul Kepple, Professional Accounting Fellow
Mike Kigin, Associate Chief Accountant
Robert Lavery, Assistant Chief Accountant
Leslie Overton, Assistant Chief Accountant
Richard Reinhard, Associate Chief Accountant
Walter Teets, Academic Accounting Fellow
Bob Uhl, Professional Accounting Fellow

Division of Corporation Finance

Robert Bayless, Chief Accountant
Craig Olinger, Deputy Chief Accountant

Division of Enforcement

Walter Schuetze, Chief Accountant

Division of Market Regulation

Les Shapiro

Division of Investment Management

John Capone
Paul Kraft

C. **AICPA**

Annette Schumacher Barr, Technical Manager

D. **Guests**

Kenny Chatelain, PricewaterhouseCoopers
Tracey Barber, Deloitte & Touche
Karin French, Grant Thornton

II. PERSONNEL CHANGES

Lynn Turner was introduced as the new SEC Chief Accountant. The three new Professional Accounting Fellows also were introduced: Eric Casey, Paul Kepple and Pascal Desroches. The new PAF's two year term at the SEC began in June. Outgoing PAFs were Donna Coallier, Armando Pimentel and Cody Smith. In addition, Scott Bayless was recently promoted to Associate Chief Accountant.

III. DISCUSSION WITH THE NEW CHIEF ACCOUNTANT

A. Committee Activities

Bob Herz introduced the Committee and provided an overview of the Committee's roles and activities. The Chairs of each of the Committee's Task

Forces gave a brief status update of the following projects:

- *SEC Conference.* Bill Travis stated that the majority of the program has been finalized for this year's conference. The Conference's past success, in terms of both attendance and participant evaluations, has led the Conference Task Force to the assembly of a program that is very similar to those of previous conferences.
- *Business Combinations.* Jay Hartig described the three projects under current consideration: (1) systematic patterns, (2) paragraph 48, dispositions, and (3) paragraph 47, alterations of equity interests. He noted that the Task Force is currently considering additional issues relating to systematic patterns and would like to complete its paper and then meet with the SEC staff within the month to discuss paragraph 48, dispositions and paragraph 47, alterations of equity interests. Bob Herz added that the ultimate objective of the Business Combinations Task Force is to create a "best practices" document that, once discussed with the staff, could be published in the Journal of Accountancy and posted to the AICPA's website.
- *Filing Issues.* Amy Ripepi stated that her Task Force has two issues on its agenda: (1) withdrawal of an auditor's report without a resignation/8-K filing and (2) Article 11 proforma presentations. With respect to the auditor's withdrawal issue, Ms. Ripepi noted the concern that the public may be left unaware of the auditor's withdrawal if there is no announcement in an SEC filing. The Task Force recommends that the staff should announce (possibly in a Staff Legal Bulletin) that the issuer should report the withdrawal under Item 5 of Form 8-K. Robert Bayless responded that Item 5 does not impose a filing deadline on an issuer for other material events. Accordingly, it is not possible to determine that an issuer has failed to meet its filing obligation. The Task Force will give further consideration to this point.
- *Employee Benefits.* Tracy Barber reported for Val Bitton who was unable to attend the meeting. She stated that the Task Force is addressing the issue of cheap stock and asked for staff volunteers who could provide the task force with live examples to consider in their deliberations. Mr. Turner noted that cheap stock has been a problem for some time and that, in his previous role as CFO, he encountered abuses of the cheap stock rules by various registrants. He stated that he would like to see guidance be provided which would help ensure that all registrants, do it right.

B. **Office of Chief Accountant: Priorities and Areas of Focus**

Lynn Turner summarized the following issues he sees as top priority for the Office of the Chief Accountant:

- *International Accounting Standards.* The IASC is expected to complete its core-standards project in the near future. The Chief Accountant's Office will need to evaluate those standards and recommend to the Commission whether current filing requirements for foreign registrants should be modified. He indicated that the agency has options available to it other than to entirely accept or reject the core standards.
- *Independence.* Mr. Turner stated that independence is an extremely critical issue and that he is excited about the creation of the

Independence Standards Board (ISB) and the role it will take in independence deliberations. He expects the ISB to issue standards after a substantive and careful due process. He also looks forward to the Board's proposal of independence standards that will permit engagement partners to make appropriate decisions about difficult accounting issues without the fear that their income or career will be jeopardized. Furthermore, he indicated that he expects engagement partners who bring difficult issues to the SEC staff to have discussed those issues first with the national office. He will not be sympathetic to a partner who proposes a questionable accounting treatment to the staff without consultation with and the backing of the partner's national office.

- *Registrant Filing Matters.* Mr. Turner stated that his office will immediately focus on a number of filing issues including business combinations, acquired research and development costs, and use of reserves in earnings management. Mr. Turner discussed these issues in detail in a speech given at the SEC Institute on June 25, 1998.
- *Organization and Staffing.* Mr. Turner noted that the size of the office is roughly the same as it was seven years ago, although there has been a significant increase in filing activity and U.S. and international standard-setting activities. He noted that the Office has two vacant positions for Assistant Chief Accountants. In addition, the Division of Enforcement has three vacant accounting positions and the Division of Corporation Finance has about ten vacancies. Mr. Turner asked the profession to assist the SEC with identifying any qualified candidates.

IV. SECTION 10A REPORTS

Scott Bayless expressed concern that the press recently has reported on a number of corporate situations suggesting illegal acts by registrants yet the staff has not received Section 10(a) letters from the company's auditors. He added that last year the SEC received ten Section 10(a) letters regarding illegal acts and this year the staff has received only one. Mike Kigin recommended that firms take a look at press reports and consider whether a Section 10(a) letter to the staff would be appropriate. He added the reminder that a resignation does not relieve auditors of their reporting obligations under Section 10(a).

V. UPDATE OF COMPANY REGISTRATIONS

Robert Bayless reported that the Division of Corporation Finance expects to present to the Commission a proposing release for a comprehensive redesign of the registration process. Among the issues being considered is a reduction in the filing deadlines for periodic reports (i.e., forms 10-K, 8-K and 10-Q). He expects to have discussions in the near future with auditors and preparers about the implications of changing the deadlines.

VI. MARKET RISK DISCLOSURES

Walter Teets made the following observations regarding market risk disclosures:

Non-bank/thrift registrants with less than $2.5 billion market capitalization should remember that they will be subject to the market risk disclosure requirements for reporting periods that end after June 15, 1998. Banks, thrifts and other registrants

with more than $2.5 billion market capitalization should have already implemented the disclosure requirements.

For those issuers who will be providing market-risk disclosures for the second year, those disclosures must be provided in a comparative format. If the issuer elects to change the format of the current year's disclosures, the prior year's disclosures must be recast in the new format, or, the current year's disclosures also must be presented in a format comparative with the prior year's information. Any material change in exposure to market risks should be reported in interim reports.

The SEC staff recently met with members of several public accounting firms to discuss registrants reactions to (1) the process involved in preparing the market-risk disclosures and (2) the effectiveness and usefulness of the disclosures with respect to registrants risk management practices and analysts market risk assessments. The SEC staff also met with analysts and others to assess further the usefulness and meaningfulness of these disclosures, as well as to consider what additional guidance might be made available to those registrants that have not yet been required to include market risk disclosures in their filings.

The staff is expected to provide its findings to the Commission in the near future, and the Commission may transmit those findings to Congress. In addition, the Commission will reconsider the accounting policy footnote requirements of the market risk disclosure rules in light of FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities.

VII. YEAR 2000

A. Staff Legal Bulletin No. 5

Robert Bayless referred the Committee to the testimony that Commissioner Unger gave before the Senate Banking Committee in June. Ms. Unger's testimony addressed the adequacy of issuer disclosures about Year 2000 readiness and the Commission's intent to issue a release about disclosure requirements. Mr. Bayless indicated that he is eager to receive the profession's input regarding the Commission's release. Bob Herz stated that the Committee has formed a Task Force to address this issue and provide input to the staff.

B. Reporting by Broker-Dealers and Transfer Agents

Les Shapiro of the Division of Market Regulation reported that the Commission has issued final rules on the reporting by broker-dealers and transfer agents of the status of their Year 2000 readiness. The final rules, which will be in the July 13 Federal Register, will require smaller broker-dealers and transfer agents to file a report that follows a standardized check-the-box format. Larger broker-dealers and transfer agents will be required to supplement the form with a more complete narrative discussion. The Commission has reopened the comment period for issues related to auditor involvement, with the expectation that it will adopt the agreed-upon approach suggested by the AICPA. (The Auditing Standards Board has indicated that it will issue a Statement of Position (SOP) that will govern agreed-upon engagements related to these reports. The SOP is expected to become final in

the fall of 1998, and the reports will be due April 30, 1999.)

Paul Kraft of the Division of Investment Management reported that the Commission also has proposed rules that would require investment advisors to file reports on their Year 2000 readiness. Advisers with over $25 million in assets under management would be required to file Part I of Form ADV-Y2K, and advisers of mutual funds would also be required to file Part II. The reports will be due thirty days after the rule becomes final, with an updated report due eight months after the first report is due. Comments are due August 10. One of the issues flagged for comment is whether auditor attestation also should be required.

VIII. REVISIONS TO RULE 102(e): DEFINITION OF IMPROPER PROFESSIONAL CONDUCT

Scott Bayless reported that the Commission has proposed rules to define improper professional conduct under Rule 102(e). The Commission proposed a definition that includes (1) intentional or knowing violations, including a reckless violation of applicable standards (e.g., GAAS) or (2) negligent conduct in the following instances:

- There has been an unreasonable violation of applicable professional standards that presents a substantial risk (which is either known or should have been known) of making a document prepared pursuant to the federal securities laws materially misleading; or
- There have been repeated, unreasonable violations of applicable professional standards that demonstrate that the accountant lacks competence.

The comment period is July 20, but it may be extended. The Commission and staff look forward to receiving comments about alternative approaches to defining improper professional conduct.

IX. PROPOSAL REGARDING MD&A AND SEGMENT REPORTING

Robert Bayless noted that the Commission has proposed technical amendments to Rules 3-03 and 12-16 of Regulation S-X, Items 101 and 102 of Regulation S-K, and Schedule 14A to conform reporting requirements with SFAS No. 131. The Commission also proposed consistent changes for Form 20-F and Sections 501.06 and 503 of the Codification of Financial Reporting Policies (CFRP). Comments are due July 31, 1998.

Mr. Bayless reminded the Committee of the staff's views regarding the disposition of a segment under APB 30 when that segment previously has not been reported as a segment under FASB standards or as a major product line in the MD&A and Description of Business sections of previously filed reports.

X. RECENT ENFORCEMENT RELEASE REGARDING SPECTRUM TECHNOLOGIES

Walter Schuetze, Chief Accountant of the Division of Enforcement, briefly discussed the Commission's order that instituted proceedings against two Arthur Andersen partners for their involvement in misstated interim financial reports for Spectrum Technologies. He stated that the decision to bring a cease and desist action against

the partners was made prior to the court's decision in the Checkosky vs. SEC case. The Commission will allege that the Arthur Andersen partners were a cause of Spectrums violation of reporting requirements.

Bob Herz indicated that George Diacont discussed this issue with the Committee last year. At that time, Mr. Diacont stated that the case might be pursued as a SAS 71 case, in that an auditor who becomes involved with interim financial reports may need to follow all the requirements of SAS 71. Mr. Schuetze responded that the case is being brought under standards of due professional care, because the partners gave advice to the issuer. The partners need not have been subject to SAS 71 nor even have been the company's auditors to have violated the due professional care standards.

XI. STAFF APPROACH TO NO NAME INQUIRIES

Jane Adams announced that the Office of the Chief Accountant will no longer consider written submissions for the staff's views unless the parties in the submission are named. The staff will accept submissions that use pseudonyms as long as the staff is informed orally of the identities of the issuers. This new policy was instituted in the wake of several lengthy no-name submissions that were amended frequently based on the staff's preliminary views. The staff believes it should give priority to those issuers who have filed a registration statement and are trying to go effective. The staff will continue to discuss its views on emerging issues that affect several issuers without requiring that issuers be identified.

XII. IMPAIRMENT OF HELD FOR SALE ASSETS UNDER FAS 121

Jeff Jones discussed a letter to Bob Herz that described the staff's views regarding accounting for assets that are held for use versus those that are held for sale under SFAS No. 121 (see Attachment A). The staff believes that assets may be considered held for sale (and depreciation no longer recorded) only if the plan of disposition is sufficiently robust, contains sufficient detail, and if management has the present ability to remove the assets from operations at any time without interrupting the business operations of the company. If the assets must be used in service for some period of time prior to being available for sale, the issuer must test the assets for impairment as assets to be held and used. In addition, the company should consider the remaining useful life and recoverability of the recorded value of the assets and continue to depreciate the assets accordingly. Mr. Jones noted that the staff has addressed issues in which the company could not remove assets from service without disrupting operations until replacement assets were received. In such instances, the assets to be disposed of are considered held and used. This position is consistent with the preliminary conclusions of the related FASB task forces report on FAS 121 implementation issues. Mr. Turner noted that it appeared some impairments may have been taken inappropriately when instead the depreciable lives of the assets should have been adjusted at an earlier date.

XIII. STAFF APPROACH TO FOLLOW-UP OF ACCOUNTING DISPUTES NOTED IN FORM 8-K FILINGS

Robert Bayless described the staff's procedure for following up on accounting issues raised in Form 8-K, Item 4 filings. He indicated that staff in the examining office will

do an initial review of the issues involved to determine their significance. If a major problem with previously filed financial statements is indicated, the matter will be referred to the Divisions Office of the Chief Accountant. If another accounting firm (including the successor auditor) agrees with the proposed accounting treatment that led to the predecessor auditor's resignation or dismissal, the Office of the Chief Accountant will be involved. That office will determine whether to make a referral to the Division of Enforcement, initiate a monitor or full review of the issuers filings, or take further action.

Lynn Turner suggested that a successor auditor who agrees with the proposed accounting treatment that led to the resignation or dismissal of a predecessor auditor should contact the SEC staff prior to accepting the audit engagement. He added that the staff would be very interested and concerned if a successor auditor allowed an accounting treatment that a predecessor auditor did not. He also urged the SECPS member firms to remind all of their partners, at least annually, of their obligation to notify the SEC staff of the termination of an auditor-client relationship.

XIV. APPLICATION OF PARAGRAPH 54 OF FAS 133

Pascal Desroches indicated that the staff will make an announcement about the adoption of SFAS No.133, Accounting for Derivative Instruments and Hedging Activities, at the upcoming EITF meeting. Upon the adoption of Statement 133, any security classified as held-to-maturity can be transferred to the trading or available-for-sale category without calling into question an entity's intent regarding other held-to-maturity securities. The staff believes that any security that is transferred from held-to-maturity on the adoption of Statement 133 and subsequently sold in the same quarter should have been transferred to the trading category upon adoption. The cumulative effect adjustment related to such a security must be included in ordinary income and should not be reported as a trading gain. The staff also reminded issuers that they may not adopt Statement 133 on a piecemeal basis. Thus, any unrealized gain or loss on the security at the transfer date should 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.

Robert Bayless added the reminder that Staff Accounting Bulletin 74 applies to Statement 133. Since Statement 133 was issued on June 17, SAB 74 disclosures should be included in the next financial statements filed after June 17. Mr. Turner noted the staff expects to monitor closely the implementation of SFAS No. 131, Disclosure about Segments of an Enterprise and Related Information, and SFAS No. 133.

XV. IMPACT OF THE EURO ON PRIOR PERIOD FINANCIAL STATEMENTS

Craig Olinger described the accounting treatment to be followed by those European companies that adopt the Euro as their functional currency for reporting purposes beginning January 1, 1999. On that date, the Euro will have a fixed exchange rate with the currencies of the countries in the European Monetary Union. That fixed exchange rate will be used to convert previously reported balances from their former functional currency to the Euro. This method is know as the convenience method.

Rule 3-20 of Regulation S-X requires the use of the same reporting currency for all

periods reported and does not permit the use of the convenience method. However, Rule 3-20 did not contemplate the creation of a new multinational currency. The staff believes that the convenience method is appropriate for those companies that switch their reporting currency to the Euro on or after January 1, 1999, because, in this case, the use of the convenience method will not affect previous trends in reported financial information. An issuer from outside the European Monetary Union that converts its reporting currency to the Euro should use the exchange rate that is in effect on January 1, 1999 to restate prior financial information. Issuers are generally expected not to switch their reporting currency to the Euro until they report on the period that encompasses January 1, 1999. EITF Topic D-71 sets forth the disclosures the staff would expect when an issuer changes its reporting currency to the Euro.

XVI. MEXICO'S HYPER INFLATIONARY STATUS

Craig Olinger stated that the staff has discussed with the AICPA International Practice Task Force whether it would be appropriate to consider Mexico as non-hyper inflationary and concluded that, based on Mexico's historical chronic inflation patterns, it would not be appropriate to cease hyper inflationary accounting before December 31, 1998. Craig Olinger noted that D-55 requires a change in inflationary status to be other than temporary before hyper inflationary accounting can be ceased; the group agreed that there was not sufficient evidence that Mexico's decline in inflation was other than temporary at this time.

XVII. PUSH DOWN ACCOUNTING

Jeff Jones discussed the staff's views regarding the application of Staff Accounting Bulletin 54 (push down accounting) to a business combination transaction. A recent case was reviewed in which two investors intended to acquire a company in which each would own 50 percent of the shares. The investors were acting in concert to mutually promote the transaction and agreed to collaborate in the subsequent management of the company. The collaboration was evidenced by corporate governance provisions where directors representing each of the investors would need to approve separately significant decisions at the board level. The staff indicted that, even though there was no legal parent, such an arrangement would require push-down accounting by the entity because the collaborative group would own more than 95% of the target. After the staff concluded on this initial proposed transaction, the transaction was restructured. A third financial investor was introduced as a 6% investor. The ownership by the members of the collaborative group was reduced to 47% each. The 6% voting and economic interest obtained by the third investor, who was an independent third party acting on their own behalf, was a substantive economic interest with normal voting rights. However, the third investor did NOT have the ability to veto decisions made by the holders of the 94% interests. As a result, the staff did not object to the company's conclusion that the third investor should not be included in the collaborative group. Since the aggregate ownership of the control group was less than 95%, the staff did not require the pushdown to the separate financial statements of the target company, although it would have been permitted.

XVIII. ADOPTION OF PLAIN ENGLISH RULES: RATIO OF EARNINGS TO FIXED CHARGES

Amy Ripepi raised the issue of the new Plain English rules and apparent changes in

the substance of the calculation of the ratio of earnings to fixed charges. Ms. Ripepi asked whether the changes were made intentionally and, if not, whether the Plain English rules would be corrected. Craig Olinger responded that in one instance the ratio numerator and denominator were inadvertently reversed and that a technical correction will be considered. In another instance, the rule that permitted earnings to include proportionate earnings of a 50 percent-owned subsidiary was changed so that earnings from a subsidiary could be included in the ratio only when the subsidiary is more than 50 percent-owned. This change was not intentional but there is no indication that the Commission will change the Plain English rule as a consequence. Mr. Olinger noted that the Plain English rules are not effective until October 31, 1998. He suggested that an issuer who wishes to include earnings from a 50 percent-owned subsidiary in the ratio of earnings to fixed charges should consult with the staff.