SEC REGULATIONS COMMITTEE
Joint Meeting with SEC Staff
March 11, 2003
SEC Headquarters - Washington, D.C.

HIGHLIGHTS

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

Jay Hartig, Chair
Gerard Brinkman
Jack Ciesielski
David Follett
John Gerdener
Chris Holmes
Jim Ledwith
Jeff Lenz
Scott Pohlman
Sam Ranzilla
Leonard Weinstock
John Wolfson

B. Securities and Exchange Commission

Office of the Chief Accountant

Scott Taub, Deputy Chief Accountant
Jack Albert, Associate Chief Accountant
Robert Burns, Chief Counsel
Cathy Cole, Associate Chief Accountant
Mike Kigin, Associate Chief Accountant
Jenifer Minke-Girard, Associate Chief Accountant

Paul Munter, Academic Fellow
Jane Poulin, Associate Chief Accountant

Division of Corporation Finance

Carol Stacey, Chief Accountant
Craig Olinger, Deputy Chief Accountant
Louise Dorsey, Associate Chief Accountant
Todd Hardiman, Associate Chief Accountant
Joel Levine, Associate Chief Accountant
Leslie Overton, Associate Chief Accountant

Division of Enforcement

Greg Scates, Associate Chief Accountant

Division of Investment Management

Brian Bullard

C. AICPA

Jennifer Roddy, SECPS
Annette Schumacher Barr

D. Guests

Karin French, Grant Thornton

II. PERSONNEL CHANGES

A. Office of the Chief Accountant (OCA)

Scott Taub stated that Jackson Day has been appointed as the Acting Chief Accountant. In other personnel matters, OCA has hired Sandra Folsom Kinsey to fill a new legal position and that the Office will hire four additional PAFs in April. In addition, OCA has been allocated 10 new positions. Announcements describing these positions will soon be posted to the SEC's website.

B. Division of Corporation Finance

Carol Stacey stated that the Division's PAF program still has availability (four of ten slots have been filled) and she encouraged qualified individuals to apply. She added that Shelley Parratt has been named the Division's new Deputy Director in charge of operations and that M&A Office Chief Dennis Garris and Associate Director William Tolbert have announced their departures.

C. Division of Enforcement

Greg Scates noted that the Enforcement Division is looking for a new Chief Accountant to replace Charles Niemeier, who recently left the Commission to serve on the PCAOB. An Acting Chief Accountant has not been named. He added that the Division will hire three to four additional accountants this Spring.

III. STATUS UPDATES

A. Staff Review of Fortune 500 10-K Filings

Carol Stacey noted that a summary of the staff's review of Fortune 500 10-K filings has been posted to the SEC website. The staff will update its *Current Accounting and Disclosure Issues Outline* to reflect items noted in this review. Asked whether the Division is planning to do this type of review again, Ms. Stacey stated that although there are no specific projects planned at this point, the staff may perform future reviews on the Fortune 1000 and/or the largest foreign private issuers.

B. Enforcement Update

Greg Scates discussed the following issues of concern to the Enforcement Staff:

Reciprocal Transactions. The Enforcement Staff continues to see transactions with no business purpose, such as contemporaneous or reciprocal transactions that are not based on fair values. He cited a number of examples in which two entities agreed to purchase assets and/or services from each other at grossly inflated values. Such transactions misstate the true nature of the transaction and are misleading to investors. He cautioned auditors to look closely at the full relationship among transacting parties.

Foreign Firms. The staff has noted in numerous instances that foreign filers are relying on the U.S. filing reviewer to such an extent that his or her objectivity as a second reviewer may be called into question. In situations where the filing reviewer has to do an extensive amount of audit work in the review process, it becomes doubtful whether the foreign firm performed a complete audit or was competent enough to perform the audit. In a sense, the filing reviewer, whose intended role is to bring some measure of objectivity and independence to the review process, then becomes a member of the engagement team. Mr. Scates stated that the U.S. filing reviewer is required to gain assurance that the foreign firm's engagement team conducting the audit has sufficient knowledge of U.S. GAAP, U. S. GAAS, and SEC rules. This assurance should be attained at the outset of the audit.

Confirmations. Mr. Scates cautioned auditors to exercise proper skepticism throughout the confirmation process. He added that auditors should maintain adequate control over the confirmation process, including the selection, mailing and receipt of all confirmations. Auditors should also gain a full understanding of business relationships and be aware of where the confirmations are sent, ensuring that confirmations are sent to the appropriate individuals. For example, confirmations should be sent to the accounting department, not the sales department.

C. Other Staff Projects

The staff gave an update of the following staff projects and activities:

Internal Controls. Division of Corporation Finance rulemaking staff are in the process of finalizing the Commission's proposed rules implementing Section 404 of Sarbanes-Oxley. Scott Taub stated that issuance of the final rules will *not* be pushed back a year and Carol Stacey added that the staff is working hard to finalize the rules as soon as possible. The Committee asked about the effective date of the final rules. Mr. Taub replied that at the current time there are no plans to change the effective date of September 15, 2003 that was specified in the proposal. Questions on Section 404 implementations should be directed to Betsy Murphy, Sean Harrison or Ray Be in the Division of Corporation Finance or Sam Burke or Randy Greene in the Office of the Chief Accountant.

Improper Influence on an Auditor. Bob Burns stated that in accordance with Section 303(a) of the Sarbanes-Oxley Act, the SEC has proposed rules to prohibit officers and directors of an issuer, and persons acting under the direction of an officer or director, from taking any action to fraudulently influence, coerce, manipulate or mislead the auditor of the issuer's financial statements for the purpose of rendering the financial statements materially misleading. He added that Sarbanes-Oxley requires that the SEC finalize its rules by April 28 and the staff intends to meet this deadline.

Study on the Use of Special Purpose Entities. Sarbanes-Oxley requires the staff to complete its study on special purpose entities within one year of the effective date of the final rules on off-balance sheet arrangements. The staff is working to complete the study within this allotted time. Questions or comments on the staff's SPE project should be directed to Jenifer Minke-Gerard or Eric Schuppenhauer in the Office of the Chief Accountant or David Smith in the Division of Corporation Finance.

Critical Accounting Policies. Jenifer Minke-Gerard stated that the Commission's proposed rules on critical accounting policies were issued before the passage of Sarbanes-Oxley and thus were not required by a legislative mandate. In order to achieve the aggressive rulemaking timetable set by Sarbanes-Oxley, the staff had to redirect resources away from the Critical Accounting Policies initiative. The staff hopes to be able to turn its attention back to this proposal this spring. In the interim, registrants should look to the cautionary advice in FR 60 as well as the guidance in the rule proposal.

Form 8-K Proposal. In June, 2002, the SEC proposed a number of Form 8-K amendments to provide investors with better and faster disclosure of important corporate events. Specifically, the SEC proposed to add 11 new items that would require a company to file Form 8-K under the Securities Exchange Act of 1934. The

SEC also proposed to shorten the filing deadline for Form 8-K to two business days after an event triggering the form's disclosure requirements.
Like the Critical Accounting Policies proposal, the Commission's 8-K proposal was not part of the regulatory schedule mandated by Sarbanes-Oxley and as such, no specific timetable was set for its finalization. Craig Olinger stated that the rulemaking staff in the Division of Corporation Finance will turn their attention to this proposal when the rules on internal controls are finalized.

Standards Relating to Listed Company Audit Committees. As directed by Section 301 of the Sarbanes-Oxley Act, the SEC has proposed a new rule to direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the audit committee requirements established by the Sarbanes-Oxley Act. Carol Stacey stated that the comment period ended on February 18 and the staff expects to issue final rules by the April 26 deadline set forth in the Act.

Study on Principles-Based Standards. The staff is in the process of developing and finalizing its study on principles-based standards, which is due the end of July. Paul Munter stated that in doing the study, the staff is defining "principles-based" and "rules-based" standards and is reviewing existing standards within the context of these definitions. He added that it would be overly simplistic to classify U.S. GAAP as either "principles-based" or "rules-based" because there are aspects of both throughout the existing literature. Scott Taub stated that this study is not intended to preempt the FASB's consideration in this area. He added that it is clear that future standards will require more judgment and that accounting professionals will be asked to "stand up and do what is right."

IV. PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD (PCAOB)

The staff made the following observations regarding the activities of the PCAOB:

Proposed Registration System. The PCAOB has posted its proposed registration system on its website (http://www.pcaobus.org). Comments are due March 31. After the comment period ends and the comments are considered by the Board, the proposed rules will be submitted to the SEC for approval. The SEC's approval process will involve another comment period. Although this rulemaking process provides two comment periods, Bob Burns encouraged interested parties to send comments to the PCAOB in the initial comment period.

SEC Oversight. Scott Taub discussed the nature of the SEC's relationship with the PCAOB. He stated that the PCAOB is a separate legal entity with its own agenda and staff. The SEC's oversight of the Board is roughly similar to the SEC's oversight of the FASB. The SEC's oversight of the Board is stronger, however, as the SEC needs to approve every rulemaking action taken by the PCAOB.

V. ACCOUNTING FOR LONG-TERM SERVICE CONTRACTS

Scott Taub stated that at the last joint meeting with the SEC Regulations Committee, the staff stated that questions have arisen regarding whether it would be appropriate to apply the percentage-of-completion (POC) method to service contracts. The staff pointed to SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts,* which clearly states that the percentage-of-completion method does not apply to service contracts. Since that time, a number of questions and concerns have been raised regarding this position. The staff is already aware of one situation in which a registrant was using the POC method to account for its straight long-term service contracts with the rationale that their costs would decrease throughout the life of the contract (because a learning curve would allow greater efficiencies in service delivery). Such accounting is not acceptable. Mr. Taub stated that both the Division of Corporation Finance and the Division of Enforcement have been alerted to the issue. Any deviations will result in a review comment and possible referral to the Enforcement staff. Mr. Taub added that the staff would welcome a referral of the issue to the EITF.

VI. DERIVATIVES

Cathy Cole stated that the FASB has indicated it will amend Statements 95 and 133 to require that cash flows associated with derivatives with other-than-insignificant financing elements at inception (such as prepaid forwards) be shown on the Statement of Cash Flows as financing activities, not operating activities. This amendment should clarify how cash flows associated with such instruments are to be treated in the statement of cash flows. Scott Taub added that while the effect of such instruments on cash flows will be made more transparent in the financial statements, the reliance on such instruments and their effects on liquidity must also receive appropriate discussion in MD&A.

VII. GOODWILL

The staff noted that paragraph 26 of FAS 142 states that goodwill should be tested for impairment on an annual basis, provided that the test is performed at the same time every year. The staff believes that the guidance in paragraph 26 should not be interpreted so rigidly that a registrant could not change the date of its annual impairment test. A registrant should not, however, change the date of its annual impairment test for the purpose of accelerating or avoiding an impairment charge. Nor should a registrant allow more than 12 months to elapse between the original annual impairment-testing date and the new date that the registrant subsequently selects. The staff further commented that such a change would be viewed as a change in method of applying an accounting principle as described in APB 20. Accordingly, the staff **would** require a registrant to obtain a preferability letter from its independent accountants when making such a change.

The staff added that paragraph 17 of FAS 142 states that an intangible asset that is not subject to amortization should be tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired. The standard, however, does not contain further stipulations with respect to when the test should occur within the year (i.e., it does not require the test be performed at the same time each year). Accordingly, the staff **would not** require a preferability letter in those instances where a registrant makes a change in impairment test date within the year.

VIII. IMPACT OF FAS 143 ON FULL COST METHOD OF ACCOUNTING

A number of emerging issues relating to the impact of FAS 143 on the full cost method of accounting under Rule 4-10 of Regulation S-X were raised. Although no conclusions were arrived at, the group acknowledged that the issues need to be addressed in order to provide necessary guidance. The staff asked the Committee to reactivate the AICPA's Full Cost Task Force (including the registrant contingent) to deliberate the issues. Jack Albert will serve as the staff point person on this issue.

IX. CONTRACTUAL OBLIGATIONS TABLE – OTHER LONG TERM LIABILITIES DISCLOSURES

The Committee noted that there is some uncertainty regarding the new contractual obligations table required by Item 303(a)(5) of Reg. S-K. Specifically, the staff has informally indicated in telephone discussions that the line captioned "other long-term liabilities reflected on the registrant's balance sheet under GAAP" should be limited to obligations within the scope of Statement 47. In response, Jenifer Minke-Gerard stated the staff will allow flexibility in what is included in this line as long as there is appropriate disclosure clearly describing what is included and what is excluded. Questions in this area should be directed to Jenifer Minke-Gerard or Eric Schuppenhauer in the Office of the Chief Accountant or Andy Thorpe in the Division of Corporation Finance.

X. NON-GAAP FINANCIAL MEASURES

The staff indicated that it plans to issue a Frequently Asked Questions document that would address issues relating to the implementation of the Commission's new rules regarding non-GAAP financial measures.

XI. CURRENT PRACTICE ISSUES

A. Transitional Pro Forma Disclosures under FASB Statement No. 143, *Accounting for Asset Retirement Obligations* (FAS 143)
Question: Should annual financial statements issued prior to the adoption of FAS 143 that are included in a registration statement be revised to include the transitional disclosures described in paragraph 27 of FAS 143 if the registration statement also includes interim financial statements which reflect the adoption of FAS 143? Would the conclusion be different if these previously issued annual financial statements are incorporated by reference, rather than included, in a registration statement?

Background: Paragraph 27 of FAS 143 states the following:

> …an entity shall compute on a pro forma basis and disclose in the footnotes to the financial statements for the beginning of the earliest year presented and at the end of all years presented the amount of the liability for asset retirement obligations as if this Statement had been applied during all years affected. The pro forma amounts of that liability shall be measured using current (that is, as of the date of adoption of this Statement) information, current assumptions, and current interest rates.

FAS 143 is effective for fiscal years beginning after June 15, 2002. Earlier application is encouraged. Initial application is as of the beginning of an entity's fiscal year. If FAS 143 is adopted prior to the effective date and during an interim period other than the first interim period of a fiscal year, all prior interim periods of that fiscal year shall be restated.

Discussion: If annual financial statements issued prior to the adoption of FAS 143 are reissued and included in a registration statement subsequent to the issuance of interim financial statements reflecting the initial adoption of FAS 143, the annual financial statements should be revised to include the paragraph 27 transitional disclosures, if the amounts involved are material. This view is based on paragraph 27, which states that disclosure of pro forma information should be provided "…for the beginning of the earliest year presented and at the end of all years presented." This view is consistent with the SEC Staff's position on transitional disclosures required by paragraph 61 of FASB Statement No. 142, *Goodwill and Other Intangible Assets* (FAS 142).

If annual financial statements issued prior to the adoption of FAS 143 are reissued via incorporation by reference into a registration statement that also incorporates by reference interim financial statements reflecting the adoption of FAS 143, it is not clear whether those annual financial statements should be revised to include the transitional disclosures required by FAS 143.

Staff Response: The staff indicated that it is deferring to the registrant and its auditors the assessment as to whether GAAP requires the transitional disclosures of SFAS 143 to be included in the most recent annual financial statements that are being reissued via incorporation by reference (i.e., NOT reproduced) into a proxy statement or registration statement that also incorporates by reference interim financial statements reflecting the initial adoption of SFAS 143. Auditing firms should decide for themselves whether they can permit reissuance of their opinion without restatement in this circumstance. However, if restated financial statements are not filed (under cover of Form 8-K, Item 5, for example) then the registration statement or proxy statement must prominently present at least, selected financial data (even though not required by instructions to the registration statement or proxy statement) that includes the transitional disclosures required by SFAS 143.

Therefore, the staff would allow for flexibility in how registrants satisfy the disclosure requirements of SFAS 143, which might be by:

1. Including the transitional disclosures in the registration statement (data for only the three most recent years and interim periods would suffice, even if the transitional disclosures are included in a five-year table);

2. Filing the required disclosures or filing the annual financial statements, revised to include the transitional disclosures, in a Form 8-K that is incorporated by reference into the registration statement; or

3. Including the transitional disclosures in a Form 10-Q that is incorporated by reference into the registration statement.

Irrespective of the method a registrant chooses for providing the transitional disclosures, the disclosures should be robust and transparent and should cover all periods for which financial statements are presented. The disclosures should include (or cross reference to) the date that SFAS 143 was adopted, a brief description of the standard, a discussion of the impact that adoption has had on the financial statements, and a discussion of the paragraph 27 transitional disclosures.

This position is similar to the Division of Corporation Finance's (DCF) position regarding the adoption of SFAS 142 subsequent to filing a Form 10-K that is incorporated by reference into a registration statement or proxy statement. DCF's position is predicated on an expectation that the auditor will consent to incorporation of its report on the annual financial statements only after assuring that the transitional disclosures required by SFAS 143 are complete and correct.

B. Classification of Equity Earnings within Operations

Question: Will there be any further guidance provided as to the specific circumstances and/or industries in which it would be appropriate to include income from equity investments within operations?

Discussion: In certain circumstances, it may be appropriate to include income from equity investments in operations. At the SEC Conference in December 2002, a member of the Staff stated, "We recognize that some companies operate their business largely through equity investees and that the operations in the equity investees are integrated into the whole. If so, Regulation S-X allows ... and it makes sense ... to include equity income of investees within operating income, but not within revenues. All amounts related to equity in earnings of investees should be included within the one-line presentation on the income statement with the components detailed in the APB 18 footnote. The one-line equity earnings of investees should include any excess purchase price amortization and any other than temporary impairment recognized."

If the view is that an equity investee may be significantly integral to the operations of the registrant to allow for classification within operations, what specific circumstances or in what industries should we expect to find such operationally integral equity investees?

Staff Response: The staff stated that it will take a facts-and-circumstances approach in determining whether an equity investee is operationally integral to the operations of the parent. The staff is not inclined to draw a bright line in this area (other than to prohibit proportional consolidations). It was agreed that the circumstances whereby an equity investee's operations are sufficiently integral to the operations of its parent to allow for classification within operations will be very limited.

C. The Status of SAB Topic 5-E

Question: Does the SEC staff have any plans to rescind SAB Topic 5-E, given the recent issuance of FIN 46?

Background: SAB Topic 5-E provides guidance on evaluating whether a legal transfer of ownership of a business results in a divesture for accounting purposes. It also provides guidance on the appropriate accounting and financial statement presentation in circumstances where a divestiture has not occurred.

In the fact pattern in the SAB, the acquiring entity had negligible equity capital, the seller financed the sale by accepting a large note from the buyer, and the nature of the business was such that there was a continued necessity for debt and contract performance guarantees on behalf of the acquirer by the seller. The SAB indicates that the seller should not account for the legal transfer as a divestiture and provides guidance for presenting the business subject to the contract in the seller's financial statements.

Discussion: In the fact pattern in the SAB, it appears that seller would be required to consolidate the business sold under FIN 46, *Consolidation of Variable Interest Entities*. It appears that the entity to which the business was sold is a VIE and that the seller has a variable interest that will absorb a majority of that entity's expected losses if they occur. Thus, except for financial statement display issues, it appears that the initial accounting would be the same under the SAB and FIN 46. In addition, FIN 46 appears to provide more explicit guidance regarding the subsequent accounting (e.g., determining whether the acquirer continues to be a VIE and whether the seller continues to be the primary beneficiary) than the SAB provides.

Staff Response: The staff does not intend to rescind Topic 5-E at this point. The staff will monitor the issue and will eliminate the SAB if and when appropriate.