THE CENTER FOR PUBLIC COMPANY AUDIT FIRMS
SEC Regulations Committee
September 13, 2004 - Joint Meeting with SEC Staff
SEC Offices – Washington DC

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.

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I. ATTENDANCE

A. SEC Regulations Committee

Jay Hartig, Chair
Rusty Brinkman
Jack Ciesielski
Greg Clifton
Melanie Dolan
David Follett
Karin French
Dave Hinshaw
Chris Holmes
Jeff Lenz
Scott Pohlman
Ted Stalick
Leonard Weinstock
Tom Weirich
John Wolfson

B. Securities and Exchange Commission

Office of the Chief Accountant

Andrew D. Bailey, Deputy Chief Accountant
Scott Taub, Deputy Chief Accountant
Jack Albert, Senior Associate Chief Accountant
Jennifer Burns, Professional Accounting Fellow
Cathy Cole, Associate Chief Accountant
Brian Croteau, Associate Chief Accountant
Chad Kokenge, Professional Accounting Fellow

Mark Mahar, Assistant Chief Accountant
Jenifer Minke-Girard, Associate Chief Accountant
Esmeralda Rodriguez, Associate Chief Accountant
Nancy Salisbury, Professional Accounting Fellow
Pam Schlosser, Professional Accounting Fellow

Division of Corporation Finance

Carol Stacey, Chief Accountant
Craig Olinger, Deputy Chief Accountant
Louise Dorsey, Associate Chief Accountant
Stephanie Hunsaker, Assistant Chief Accountant
Todd Hardiman, Associate Chief Accountant
Rachel Mincin, Associate Chief Accountant
Leslie Overton, Associate Chief Accountant
David Sherman, Academic Fellow
Sondra Stokes, Associate Chief Accountant

Division of Enforcement

Susan Markel, Chief Accountant

Division of Investment Management

Brian Bullard, Chief Accountant
Toai Cheng, Assistant Chief Accountant

C. AICPA Center for Public Company Audit Firms

Lillian Ceynowa
Annette Schumacher Barr

D. Guests

Bob Guido, PwC

II. RECENT ORGANIZATIONAL AND STAFF CHANGES

A. Office of the Chief Accountant (OCA)

Scott Taub provided the following update of organizational and staff changes in OCA:

- Brian Croteau has been hired as an Associate Chief Accountant dealing with audit issues.
- OCA has posted positions for a tagged data/XBRL retrieval specialist and a valuation specialist.
- A new position for an additional Deputy Chief Accountant has been approved and posted. The new deputy will deal with international issues. A selection has been made for this position but the name has not yet been announced.

- OCA plans on posting six additional positions by the end of the month. Audrey Gramling and Jonathan Glover have been selected as OCA's new Academic Accounting Fellows.

B. Division of Corporation Finance

Carol Stacey provided the following update of organizational and staff changes in the Division of Corporation Finance:

- The Division currently employs approximately 500 staff members, 250 of whom are accountants.
- The Division's Chief Accountant's Office has filled three positions. Two new Associate Chief Accountants have been hired: Sondra Stokes and Rachel Mincin. In addition, Stephanie Hunsaker has been hired as an Assistant Chief Accountant.
- David Sherman has been selected as an Academic Accounting Fellow in the Division.
- Each of the 11 industry offices has selected 1-3 Accounting Branch Chiefs who will supervise the work of staff accountants and report to the respective Senior Assistant Chief Accountants.

C. Division of Enforcement

- Susan Markel stated that three or four accounting positions remain open in the Enforcement Division.
- The Division maintains approximately 120 accounting personnel nationwide, 40 of which work out of the SEC's Headquarters in Washington.

D. Division of Investment Management (IM)

- Brian Bullard stated that IM has hired one additional person.
- IM Deputy Director Cynthia Fornelli has announced that she is leaving the Commission.

III. NEW ISSUANCES/RELEASES

The staff commented on the status of the following recent issuances, releases and proposed rulemaking activities:

A. PCAOB No. 2 and PCAOB No.3

- Both standards have been approved by the Commission.

B. Asset-Backed Securities Proposed Rulemaking

- The comment period is closed.
- The staff is currently in the process of reviewing comments and hopes to finalize the rules this year.
- Update: The final rule was issued on December 22, 2004.

C. Temporary Postponement of the Final Phase-In Period for Acceleration of Periodic Report Filing Dates

- Comment period ends October 1, 2004
- The staff expects to receive additional comments but sees no reason why the release will not be issued as proposed.

Update: The final rule was issued on November 17, 2004.

D. 2004-2009 Strategic Plan

- The Staff commented that the Strategic Plan (the "Plan") incorporates elements that will be implemented over a 5-year period.
- The SEC intended the plan to provide guidance regarding its goals, risk management process and policies.
- There are no imminent rulemaking releases based on the Plan.
- The Staff may consider issuing further interpretive guidance on MD&A.

E. Public Release of Comment Letters and Responses

- This initiative applies to filings made after August 1, 2004 - it is based on the primary document that is being reviewed (e.g. in a review of a registrant's 2003 Form 10-K and September 30, 2004, the Form 10-Q would not be subject to posting since the 2003 Form 10-K is the primary document reviewed).
- The timeframe for posting is not currently determinable but would likely be sometime in the fall.
- The Staff is currently working on the technology required for the postings.
- There will likely be 45 day lag between the clearing of comments and posting the final responses to EDGAR.
- Staff in the Division of Corporation Finance will notify companies when the review is completed.
- The Staff is considering whether to delay the posting of final responses in merger/acquisition-related registrations until the deal is closed.
- The Staff is now including "Tandy" language in all comment letters.
- On average, the Staff notes that a high percentage of Rule 83 confidentiality requests are ultimately not supported in the FOIA process. Registrants cannot request confidentiality on the entire letter.
- In a follow-up question regarding the Staff's common request for supplemental information, the Staff commented that the comment letter process and the types of questions/comments issued will not change.

F. FAQ on Management's Report on Internal Control Over Financial Reporting and Disclosure

- Both the PCAOB and the SEC hope to release the additional FAQs in the near term

Note: On October 6, 2004, the PCAOB and the SEC each released their FAQ documents as referenced above.

G. Joint Interagency Statement on Sound Practices on Complex Structured Finance Activities

- The Division of Market Regulation and the Office of Compliance Inspections and Examinations were working with the banking regulators on this Statement.
- The comment process is closed.
- The Staff is currently in the process of reviewing comments and determining how to take the release forward.
- The timing of final issuance has not been determined.

H. First-Time Application of IFRS

- The proposed rule applies to a company that is fully adopting IFRS for the first time. The Commission has proposed to accept two year audited financial statements with the first time adoption of IFRS.
- The comment process is closed.
- The Staff has reviewed the comments and is considering what, if any, changes should be made. The next step is to go the Commission to adopt final rules.
- The timing of final issuance has not been determined.

IV. STATUS UPDATE OF PROJECTS/ISSUES

The staff commented on the status of the following projects and issues:

A. Securities Act Reform

- The Staff is working diligently on this project. A specific timeframe for issuance has not been set.
- Four main topics include: 1) communication issues, 2) offerings by seasoned issuers (i.e., shelf offerings), 3) liability issues, and 4) removing obstacles related to private offerings.
- The staff will not hold up the asset-backed securities final rules for this project.
- Update: The rule proposal was issued on November 3, 2004

B. Other rulemaking projects

- Executive compensation governance and disclosure (potential project).
- Voluntary financial reporting using XBRL. Update: The rule proposal was issued on September 27, 2004. The final rule was issued on February 3, 2005.

C. Project to Study and Update Materiality and Unadjusted Difference Guidance

- Internally, the Staff continues to assess the Iron Curtain vs. Rollover method.
- The Staff indicated that by providing this guidance its hopes to a) achieve consistency and b) eliminate "hanging" balance sheet errors for an indefinite period of time.
- The Staff hopes to begin drafting guidance in the next month to six weeks, with the goal of issuing the guidance in early 2005.
- The Staff commented that it will need to deal with the transition issue and hopes to achieve a practical answer. The Staff also commented that it would not expect this guidance to be applied for fiscal 2004.

- The Staff noted that it was unsure as to what form this guidance would take – i.e. Staff Accounting Bulletin or a Financial Reporting Release. The committee commented that the staff should consider allowing outside parties to comment.

D. Reference Material Updates (Staff Training Manual, Outlines)

- The Division of Corporation Finance Staff has started the process of updating its Staff Training Manual. Stephanie Hunsaker is coordinating the effort.
- The timeframe for finalizing the update is currently uncertain.
- Updates of domestic and international outlines are also in process. The Staff's goal is to have the updated domestic outline completed by the date of the AICPA SEC Conference in December.
- The Staff is also considering issuing an MD&A outline.

V. OTHER MATTERS

A. Impact of 404 Reporting on "Date of Issuance"

- This issue involves the question of whether a registrant can issue a glossy annual report that includes a financial statement opinion without having on file with the commission an audit report on internal controls over financial reporting (the 404 report)?
- The Staff stated that its initial view was that the financial statement report and the 404 report should not be separated but added that it would discuss the issue with the PCAOB and finalize its own views.

Note: On October 6, 2004, the SEC issued a revision to its publication entitled Management's Report on Internal Control over Financial Reporting and Disclosure in Exchange Act Periodic Reports – Frequently Asked Questions (FAQ). Regarding the date of issuance matter, question No. 22 of the FAQ, states that "the intent of Section 404 of the Sarbanes-Oxley Act and the Commission's rules is that a registrant's audited financial statements with an accompanying audit report that are contained in or accompany a proxy statement or consent solicitation statement also be accompanied by management's report on internal control over financial reporting and the auditor's report on management's assessment of internal control over financial reporting. We intend to recommend to the Commission that amendments be made to Rules 14a-3 and 14c-3(a) and Item 13 of Schedule 14A to include such a requirement. In the interim, we encourage issuers to include both management's report on internal control over financial reporting and the auditor's report on management's assessment of internal control over financial reporting in the annual report to shareholders when their audited financial statements are included. If management states in their report that internal control over financial reporting is ineffective or the auditor's report takes any form other than an unqualified opinion and these reports are not included in the annual report to shareholders, our view is that an issuer would have to consider whether the annual report to shareholders contained a material omission that made the disclosures in the annual report misleading."

Update: Question 22 of the FAQ has been updated by Question 8 of Exemptive Order on Management's Report on Internal Control over Financial Reporting and Related Auditor Report Frequently Asked Questions issued January 21, 2005

B. Summary of Item 4.02 Audit Practices Task Force Discussions with the Staff.

- The staff agreed with the views presented in Attachment A.
- The staff further commented that all restatements will be based on the facts and circumstances of the restatement.

C. Incorporating 404 reports by reference in 1933 Act filings

- The Staff believes that management and auditor 404 reports in annual reports need to be incorporated into 1933 Act filings that incorporate those annual reports by reference. The Staff also added that auditors will need to consent to the incorporation of the report.
- The Staff expects this issue to be addressed in the soon-to-be-issued FAQ document.
- Update: See question 21 of the FAQ as revised October 6, 2004.

D. Adequacy of SFAS No. 133 Disclosures in Financial Statements

- The Staff asked the Committee for its general views regarding the adequacy of the SFAS No. 133 disclosures in financial statements.

- The Committee commented that it is in process of compiling comments and would follow-up with the Staff to discuss the feedback.

E. Application of AICPA Practice Aid, *Privately-Held-Company Equity Securities Issued in Other Than a Business Combination*

- The Committee asked the Staff how this paper is being applied by staff in the Division of Corporation Finance. This question was asked because several Committee members noted SEC reviewer comments that appeared inconsistent with the Practice Aid.
- The Staff commented that while they were not aware of any inconsistent comments, it could take some time for Staff reviewers to insure that that staff comments were consistent with the Practice Aid. It was recommended that any registrant with specific issues or questions should contact its SEC reviewer to discuss these issues further.
- The Staff also commented that it will continue to review estimates and assumptions regarding valuations and issue comments accordingly.

F. Interpretive Issue Regarding Question 1 of the SEC's FAQ Document on Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports

- The SEC staff's views as to which consolidated entities must be included in management's report on internal controls under SEC 404 of Sarbanes-Oxley are provided in Question 1 of the FAQ Document on Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports.

  The staff stated that they would typically expect management's report on internal control over financial reporting to include controls at all consolidated entities, irrespective of the basis for consolidation. However, in a situation

where the entity was in existence prior to December 15, 2003 and is consolidated by virtue of Interpretation No. 46 (i.e., would not have been consolidated in the absence of application of that guidance) and where the registrant does not have the right or authority to assess the internal controls of the consolidated entity and also lacks the ability, in practice, to make that assessment, the staff believes that management should provide disclosure in the body of its Form 10-K or 10-KSB regarding the lack of internal control assessment, significance of the entity to the company's financial statements, and other relevant information regarding such entities.

Some registrants have asked whether the permitted exclusion of the controls of certain consolidated variable interest entities (VIE's) from management's report on internal controls as discussed in response to Question 1 of the FAQ depends on the entity's formation predating December 15, 2003, or on the registrant's involvement with the variable interest entity predating December 15, 2003. The staff believes that even if the VIE existed prior to December 15, 2003, the VIE's internal controls would be required to be covered in management's 404 report if the registrant's initial involvement with the VIE occurred after December 15, 2003.

G. Role of the AICPA SEC Regulations Committee

- The Staff commented that the role of the Committee was recently discussed with the Executive Committee of the Center for Public Company Audit Firms.
- The Committee commented that it has been informed of the discussion and that it looks forward to working with the Staff in identifying and implementing improvements.

VI. CURRENT PRACTICE ISSUES

Discussion Document A

Topic: Application of EITF 03-06 when a registrant prepares a new or amended registration statement.

Background: In March 2004, the EITF reached a final consensus on Issue 03-6. This consensus, among other items, requires that the two-class method be used for participating securities in the computation of EPS. The transition provisions of EITF 03-6 require restatement of prior period financial statements presented for comparative purposes. This consensus is effective for fiscal periods beginning after March 31, 2004.

Question: Must a registrant who is preparing a new or amended registration statement or proxy statement that includes or incorporates by reference financial statements as of a date on or after the date the company has adopted EITF 03-6 restate its prior period annual financial statements that are included or incorporated by reference in the registration statement/proxy to reflect the retroactive application of the consensus guidance?

View A: The registrant must restate its prior period annual financial statements that are included or incorporated by reference in the registration statement/proxy to reflect the retroactive application of EITF 03-6 (as would be required by Item 11 of Form S-3--accounting change that requires restatement).

View B: The registrant must restate its prior period annual financial statements that are included (i.e., reproduced) in the registration statement/proxy. However, if the prior period annual financial statements are incorporated by reference in the registration statement, the registrant would not necessarily be required to restate those prior period annual financial statements for the retroactive application of EITF 03-6. The accommodation approach that has previously been afforded, by administrative practice, to stock splits, the initial adoption of FAS 128, the transitional disclosures relating to FAS 142 and 143 and the adoption of FAS 145 would be available to registrants following the adoption of EITF 03-6

Under the "accommodation" approach, it would be the responsibility of the registrant and its independent registered public accounting firm to make the assessment as to whether GAAP requires the restatement of the most recent annual financial statements that are being reissued via incorporation by reference (i.e., NOT reproduced) in a proxy statement or registration statement that also incorporates by reference interim financial statements already reflecting the initial adoption of EITF 03-6.

The independent registered public accounting firm should decide for itself whether it can permit reissuance of its audit report without restatement in this circumstance. However, if restated financial statements are not filed (under cover of Form 8-K, 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 restated earnings per share (and, if applicable, earnings applicable to common stock) information for all affected periods (e.g., all 5 years). Alternatively, registrants could convey the revised information by filing it in a Form 8-K that is incorporated by reference into the registration statement or proxy; or by including the revised annual earnings per share disclosures in a Form 10-Q that is incorporated by reference into the registration statement or proxy.

Irrespective of the method a registrant may choose for conveying the revised information, the disclosures should be robust and transparent and should cover all annual periods for which financial statements are incorporated by reference. The disclosures should include (or cross reference to) the date that EITF 03-6 was adopted, a brief description of the standard, the revised accounting policy and a discussion of the impact that adoption has had on the financial statements.

As in other instances, the accommodation would be granted with the expectation that the independent registered public accounting firm will consent to incorporation of its report on the annual financial statements only after assuring that the restated information required by EITF 03-6 is complete and correct.

Committee Recommendation: The committee supports View B. The committee believes that a sufficient level of context could be presented to provide readers with an appropriate level of information but that the level of disclosure would likely be significantly more than has been generally provided in the case of a stock split (e.g., full EPS footnote disclosure may be required).

Staff Response: The Staff does not object to View B. The Staff noted that the adoption of EITF 03-06 is obviously more complicated than a stock split, as an example, and, in that regard, commented that disclosures in the registration statement could be quite extensive (i.e. those disclosures could include all the disclosures required by FAS 128 in a footnote to the selected financial data). The Staff further noted that the extent of disclosures that should be included in the registration statement under the "FAS 128 accommodation

approach" should also factor into the auditor's judgment as to whether restatement of a registrant's prior period annual financial statements is required.

Discussion Document B

Topic: Complying with Staff Accounting Bulletin Topic 6.B When There Are Outstanding Participating Securities

Background: Staff Accounting Bulletin Topic 6.B requires registrants to present income or loss applicable to common stock on the face of the income statement when the amount differs from net income (or loss) by 10% or more. See also Appendix A, section V.R (page A-23) of the SEC Staff Training Manual (2000 edition).

Topic 6.B specifies that: "[t]he amount to be reported [as income applicable to common stock] should be computed for each period as net income or loss less: (a) dividends on preferred stock, including undeclared or unpaid dividends if cumulative; and (b) periodic increases in the carrying amounts of instruments reported as redeemable preferred stock (as discussed in Topic 3.C) or increasing rate preferred stock (as discussed in Topic 5.Q)."

Issue: The calculation requirements of SAB Topic 6.B do not appear to consider the possibility that participating securities might exist and that the numerators used in earnings per share computations might reflect the allocation of some portion of net income (other than dividends and accretion on preferred stock) to a class of participating securities.

Question: What amount should a registrant present on the face of its income statement as "income applicable to common stock" pursuant to Topic 6.B?

View A: Notwithstanding the calculation guidance set forth in Topic 6.B, the amount(s) that should be disclosed on the face of the income statement as income applicable to common stock is (are) the numerator(s) used in the calculation of basic (and diluted) earnings per share (subject to the 10% threshold contained in Note 2 to Topic 6.B). Therefore the disclosure should reflect the application of paragraphs 60-61 of FAS 128 as well as the guidance contained in EITF Issue 03-6.

View B: The amount of income applicable to common stock presented on the face of the income statement should continue to be calculated in accordance with the guidance set forth in Topic 6.B.

Committee Recommendation: The Committee supports View A. The Committee believes that the most relevant information to a common stockholder is the amount of earnings that would be available to him/her after considering the impact of all other securities (including participating securities) that have the right to earnings that would otherwise be available to common stockholders. The Committee also notes that this View A would be consistent with the financial statement note disclosures required by FAS 128/EITF 03-6.

Staff Response: Prior to taking a view, the Staff requested that the committee provide it with more information on what the Committee believes was existing practice for applying SAB Topic 6.B when there were participating securities prior to the adoption of EITF 03-06.

Discussion Document C

Topic: Clarification of SEC's position on "managed basis" non-GAAP disclosures in MD&A

Background: Managed basis disclosures are common non-GAAP disclosures found in the MD&A section of registrant filings with significant securitization activities. The premise behind managed basis is that it presents financial information on the assumption that previously securitized assets which qualified for sale accounting treatment under FAS 140 remain on the balance sheet of the transferor. Commonly, managed basis disclosures are made for performance measures (such as operating income) and for portfolio credit statistics (non-accruals, charge-offs, delinquencies). Adjustments include adding the relative off-balance sheet statistics to the on-balance statistics and (for the performance measures) reclassing certain P&L items to reflect the accounting results that would have been reported if the assets had remained on-balance sheet. Practice seems to have been mixed on whether or not performance measures eliminated the gain/loss on the sale of the asset.

Question 1: Are managed basis disclosures permissible non-GAAP disclosures in MD&A under Regulation S-K Item 10(e) ("S-K 10(e)")

View A – Non-GAAP measures should not eliminate the effects of certain accounting standards. Managed basis disclosures effectively reverse the effects of applying FAS 140 and therefore should not be a permissible disclosure.

View B – Managed basis disclosures with respect to portfolio credit statistics provide useful measures for investors in understanding the overall underwriting abilities of the registrant, the potential for future credit losses, and insights into what the registrant keeps on-balance sheet versus the assets it decides to securitize. Further, managed basis portfolio credit statistics are considered operating statistics as opposed to non-GAAP measurements and therefore are not subject to the S-K 10(e) rules. However, similar to View A, managed basis performance measures are not permissible under S-K 10(e) as they effectively eliminate the effects of applying FAS 140.

View C – Full managed basis disclosures are acceptable and useful disclosures, provided that the appropriate disclosures under S-K 10(e) are made.

Committee Comment: We have seen all three approaches outlined above used by registrants with View B being the most common approach. We would appreciate hearing the Staff's views.

Question 2 – What are the Staff's views as to whether the gain/loss on the sale of the assets should fully reflect the reversal of the securitization, including eliminating the recorded gain/loss on the sale of the asset?

Staff Response: The Staff has not yet reached a consensus on a view. The staff analogized this presentation to the "system-wide sales" presentation which was a common MD&A disclosure used by companies in the retail industry with both company owned stores and franchises (i.e. this presentation combined revenue from owned stores and its franchisees). The Staff views such presentation of system-wide sales as prohibited under Item 10 but has generally commented it would accept such presentation as a supplement to selected financial data in a discussion regarding how a registrant calculates its franchise fees.

In regard to "managed basis" presentation, the SEC staff noted that, when an entity has retained interests in securitized financial assets at the latest balance sheet date, FAS 140 requires the disclosure of certain information (e.g., the total principal amount outstanding, the related delinquencies at the end of the period, and credit losses, net of recoveries, during the period) on a "managed basis" by major asset type. In addition, some registrants follow a "managed basis" approach in presenting segment information under FAS 131. Further the staff noted that it is considering the appropriateness of "managed basis" disclosures and may clarify its views (e.g., at the November AICPA Banking Conference). The Staff further commented that if such a presentation is used or discussed as a combined performance measure, it would likely be problematic and that it does not generally support "undoing GAAP accounting".

Discussion Document D

Topic: "Five-Day Letter" SEC Files

Background

On April 18, 2003 the PCAOB adopted Rule 3400T as part of its Interim Professional Standards. Rule 3400T designates certain former AICPA SEC Practice Section (SECPS) membership requirements as interim quality control standards.

Rule 3400T requires a registered public accounting firm that has been the auditor of an SEC registrant and has resigned, declined to stand for reelection, or been dismissed, to report the fact that the "relationship has ceased directly in writing to the former SEC client, with a simultaneous copy to the Office of the Chief Accountant of the Securities and Exchange Commission" by the end of the fifth business day following the firm's determination that the relationship has ended, irrespective of whether or not the SEC registrant has reported the change in a timely-filed Form 8-K.

Prior to the PCAOB adopting Rule 3400T, auditors sent copies of "five-day letters" to the SEC's "SECPS Letter Files" in the Office of the Chief Accountant.

Question: Since the SECPS no longer exists, to what SEC files should five-day letters now be copied?

Staff Response: Copies of the letters should be sent to "PCAOB Letter Files".

Discussion Document E

Topic: Application of 404 Reporting to Acquired Businesses

Background: In the June 24, 2004 FAQ published by the SEC, Question #3 refers to late year acquisitions and the practical limitations which may exist on management completing its control assessment and reporting thereon in the shortened time frame between date of acquisition and date of reporting. In summary, it states that in cases where it is not possible to complete the assessment and to report in such time frame, management may omit the acquired entity from its assessment scope. The FAQ goes on to say however that an entity may not be omitted from more than one assessment or report and the assessment may not be deferred for more than one year from date of acquisition. In the intervening period, Registrants remain obligated to discuss changes in their controls that may have ensued as a result of the acquisition.

Issue: FAQ #3 uses the terms "business" and "purchase business combination" pervasively. As discussed in SFAS No. 141, par. 9 et seq, acquired entities that do not meet all of the several criteria of EITF 98-3, would not qualify for business combination accounting. Footnote #6 to par. 9 of SFAS No. 141 indicates that a future FASB project is expected to deal with other events and transactions that are similar to a business combination. We observe that the FASB's current deliberations in Phase II of its Business Combinations project have tentatively expanded the scope "businesses" by removing the presumption in EITF 98-3 that a development stage company is not a business. This conclusion, as well as others that will expand the scope of SFAS No. 141 accounting will not become effective until a final standard is issued, likely in 2005.

In our experience, there are many significant transactions which should in the normal course of business require a registrant to review the controls in the transferred set of activities, items or elements acquired. However, these acquisitions must be accounted for as asset acquisitions solely because they do not meet all the criteria of EITF 98-3. As a result, significant expansions of a business may occur presenting the very same challenges to registrants as those created by making a SFAS 141/EITF 98-3 qualifying business combination. A literal reading of FAQ #3 indicates those registrants would not be allowed to exclude those acquired activities from their control assessments and reports.

Questions:

- Did the SEC staff intend that the guidance in FAQ#3 would only apply to transactions accounted for as a purchase business combination?

Illustrative acquisition transactions that would not qualify as a purchase business combination:

1. Acquisitions of development stage enterprises where planned principal operations have not commenced. (There is significant M&A activity among companies developing high-technology, biotech/pharma and other types of products. These companies may remain in the development stage for an extended period of time and have significant control systems in need of assessment.) As indicated in EITF 98-3, a development stage company is presumed to not be a "business".

2. Carveout businesses involving the purchase of a product line in which the employee base and manufacturing facilities do not accompany the transferred set of activities. Depending on the magnitude of the inputs, processes and outputs not acquired in these

transactions, as defined in EITF 98-3, the transferred set may not qualify as a "business". Examples of such circumstances are provided in EITF 98-3 and are also found in practice.

3. A life insurance company may purchase a portion of another insurer's operations under a reinsurance arrangement. Under this arrangement, the buyer assumes all the risks and rewards of the policies, but such acquisitions do not qualify under EITF 98-3 as a "business" acquisition. These life insurance company reinsurance transactions have many of the same issues surrounding testing internal controls as do business combinations. For a period of time, until controls can be tested, significant financial statement amounts will be based on the internal controls put in place by the seller. The thousands of insurance contracts involved are maintained on an administrative system that is, typically, the seller's system. Whether the company had purchased an entity including its systems and employees or just reinsured all the results of the insurance contracts through a reinsurance contract, the systems generating the financial information are the same. It will take time for the reinsurer to assess and test its own internal control system. We would also observe that the seller will be considered a service provider for the entity. However, since this role may be new to both parties, the necessary SAS 70 work may not have been previously contemplated by the parties and completed.

4. In the public utility industry, power plants may be acquired in the non-regulated portion of a registrant's business. The SEC position being followed by registrants is that these are not businesses qualifying under EITF 98-3. Therefore, significant expenditures may be made for complex operations involving important control systems as to which such acquirers would receive no relief under FAQ #3. The SEC does not afford such transactions "sale of a business" treatment as power plants are considered asset sales.

Committee Recommendation: Because of the restrictive nature of the tests of EITF 98-3, we would propose that the SEC staff consider adding a note to FAQ#3 to highlight the fact that the example given assumes that a transaction is a purchase business combination, but that the relief might be available in other fact patterns such as those described above.

Staff Response: The Staff stated that this issue would be addressed in the soon to be released FAQ document, however, stated that the above examples "put up a reasonable fence" around the exceptions. On October 6, 2004, changes were made to the FAQ clarify the answer to Question 3.

Question 3 (from the FAQ) - ***(Emphasis Supplied)***

Q: If a registrant consummates a <u>**material purchase business combination**</u> during its fiscal year, must the internal control over financial reporting of the acquired business be included in management's report on internal control over financial reporting for that fiscal year?

A: As discussed above, we would typically expect management's report on internal control over financial reporting to include controls at all consolidated entities. However, we acknowledge that it might not always be possible to conduct an assessment of an acquired <u>business's</u> internal control over financial reporting in the period between the consummation date and the date of management's assessment. In such instances, we would not object to management referring in the report to a discussion in the registrant's Form 10-K or 10-KSB regarding the scope of the assessment and to such disclosure noting that management excluded the acquired <u>business</u> from management's report on internal control over financial reporting. If such a reference is made,

however, management must identify the acquired business excluded and indicate the significance of the acquired business to the registrant's consolidated financial statements. Notwithstanding management's exclusion of an acquired business's internal controls from its annual assessment, a registrant must disclose any material change to its internal control over financial reporting due to the acquisition pursuant to Exchange Act Rule 13a-15(d) or 15d-15(d), whichever applies. In addition, the period in which management may omit an assessment of an acquired business's internal control over financial reporting from its assessment of the registrant's internal control may not extend beyond one year from the date of acquisition, nor may such assessment be omitted from more than one annual management report on internal control over financial reporting.

Update: As noted above, on October 6, 2004**,** changes were made to the FAQ to add a footnote that defines the term "business" as used in Question 3 and its response.

Discussion Document F

Topic: Internal Control Reporting Requirements Following an IPO

Background:
Following an IPO, a new registrant may file a Form 8-A to register under Sections 12(b) or 12(g) of the Exchange Act. In that case, the new registrant would be required to file a full annual report with the SEC within the due date specified by the applicable form.

Exchange Act Rule 15d-2 provides for the filing of a special financial report in circumstances where a Securities Act registration statement goes effective following the end of the issuer's most recent fiscal year without audited financial statements for that year. In that case, the new registrant would file its first full annual report with the SEC for the fiscal year in which the IPO registration statement became effective.

Rule 15d-2(a) states, "If the registration statement under the Securities Act of 1933 did not contain certified financial statements for the registrant's last full fiscal year (or for the life of the registrant if less than a full fiscal year) preceding the fiscal year in which the registration statement became effective, the registrant shall, within 90 days after the effective date of the registration statement, file a special report furnishing certified financial statements for such last full fiscal year or other period, as the case may be, meeting the requirements of the form appropriate for annual reports of the registrant. If the registrant is a foreign private issuer as defined in [Rule 405 of Regulation C], then the special financial report shall be filed on the appropriate form for annual reports of the registrant and shall be filed by the later of 90 days after the date on which the registration statement became effective, or six months following the end of the registrant's latest full fiscal year."

Rule 15d-2(b) states, "The report shall be filed under cover of the facing sheet of the form appropriate for annual reports of the registrant, shall indicate on the facing sheet that it contains only financial statements for the fiscal year in question, and shall be signed in accordance with the requirements of the annual report form."

Question 1: Would the new registrant be required to comply with Item 308 of Regulation S-K in a special financial report filed under Exchange Act Rule 15d-2?

View A - Yes. Reporting on internal control over financial reporting is integral to the presentation of financial statements of a registrant. PCAOB 2 recognizes this by requiring the

independent registered public accounting firm to perform an integrated audit of an issuer's financial statements and its internal control over financial reporting. Rule 15d-2 was adopted before Item 308 of Regulation S-K was adopted. Following the Section 404 transition period, it would not be good public policy for the initial reporting on an issuer's internal control over financial reporting to occur more than a year from the effective date of a registrant's IPO.

View B - No. Rule 15d-2 is clear that a special report only is required to include audited financial statements.

Committee Recommendation: The committee supports View B.

Staff Response: The Staff had not yet reached a consensus on a view as of the date of the joint meeting.

Question 2: Would the new registrant that files a Form 8-A to register under Sections 12(b) or 12(g) of the Exchange Act be required to comply with Item 308 of Regulation S-K in its first SEC annual report?

View A - Yes. There are no exemptions from the requirements of the annual report form for new issuers.

View B - No. Because the new registrant was not public as of the end of its most recent fiscal year, S-K Item 308 disclosures would not be required. Had the IPO registration statement included financial statements of the most recently completed fiscal year, the new registrant would not have been required to report on internal control over financial reporting with respect to that year. Further, Exchange Act registration statements on Form 10 are not required to provide the disclosures under S-K Item 308.

Committee Recommendation: The committee supports View B.

Staff Response: The Staff had not yet reached a consensus on a view as of the date of the joint meeting.

Document Discussion G

Topic: Contingent Consideration in Applying the Investment Test in Rule 1-02(w)

Background: For purposes of measuring significance under Rule 1-02(w) of Regulation S-X, the SEC's Staff Training Manual ("STM") (Topic Two, I.D.1.a)) states that the investment test should:

> "Include contingent consideration as part of the total investment in the acquiree unless the likelihood of its payment is remote. [SP]"

Neither Rule 1-02(w) nor the SEC's STM addresses whether the gross amount or the fair value of the contingent consideration should be included in the investment test.

Under FASB Statement No. 141, *Business Combinations* ("Statement 141"), contingent consideration generally is not recorded until the contingency is resolved and the consideration is issued or becomes issuable. At that time, Statement 141 requires the acquiring entity to record consideration issued or issuable at fair value.

The *Summary of FASB Tentative Decisions on Business Combinations as of July 27, 2004* ("FASB's Tentative Decisions"), would amend Statement 141 to require the acquiring entity to record the fair value of the contingent payments based on the circumstances that existed at the acquisition date. The FASB's Tentative Decisions indicate that a probability-weighted approach, such as the expected cash flow discussed in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, may be useful in estimating the fair value of contingent consideration.

Question: If the likelihood of payment is more than remote, should the registrant include the gross amount or the fair value of the contingent consideration in the investment test?

View A – If the likelihood of payment is more than remote, the registrant should include the gross amount of the contingent consideration in the investment test. The purpose of the SEC staff's position is to determine the maximum possible significance assuming the issuance of any contingent consideration considered reasonably possible.

View B – The registrant should include the fair value of the contingent consideration in the investment test. View B is more consistent with the amount of the purchase price that would be recorded under the FASB's Tentative Decisions. The fair value of contingent consideration would give effect to both the timing and likelihood of its issuance.

Committee Recommendation: The committee believes View A is acceptable but would change its view to View B when the conclusions set forth in the FASB's Tentative Decisions are finalized and effective.

Staff Response: The Staff takes View A, however, as noted in the committee recommendation, would reexamine if the FASB were to adopt the conclusions set forth in the Tentative Decisions release.

Discussion Document H

Topic: Applying the Limited Safe Harbor for Failure to File Certain Information Required by the New Form 8-K Rules

Facts: Company X is a calendar year-end SEC registrant. On December 30, 2004, an event occurred with respect to Company X that is required to be reported under Item 1.01 of Form 8-K. Pursuant to the rules of the form, the 8-K report is due on January 6, 2005 (the 4th business day after the occurrence of the event).

What is the latest date that Company X may file the disclosures required by Item 1.01 of Form 8-K with respect to the event that occurred on December 30, 2004—considering the limited safe harbor provisions for failure to file certain information required by the new Form 8-K rules. [Assume that the disclosures are not required to be made for any purposes other than complying with the requirements of Form 8-K.]

View A: The disclosures must be made no later than the due date of Company X's Form 10-K for the year ended December 31, 2004 (i.e., the periodic report for the quarter in which the event occurred).

View B: The disclosures must be made no later than the due date of Company X's Form 10-Q for the quarter ended March 31, 2005 (i.e., the periodic report for the period in which the Form 8-K was not timely filed).

Discussion: In connection with the adoption of its new Form 8-K rules (Release 33-8400), the SEC amended Exchange Act Rules 13a-11 and 15d-11 to provide that "no failure to file a report on Form 8-K that is required solely pursuant to Item 1.01, 1.02, 2.03, 2.04, 2.05, 2.06 or 4.02(a) of Form 8-K shall be deemed to be a violation of [Section 10(b) of the Exchange Act or Exchange Rule 10b-5]."

The adopting release contains the following passage:

> We are amending Forms 10-Q, 10-QSB, 10-K and 10-KSB to provide that the new safe harbor extends only until the due date of the periodic report of the company **for the relevant period in which the Form 8-K was not timely filed**. Thus, for example, if an event occurs that required the filing of a Form 8-K during a particular quarter, but the company fails to make the required timely disclosure on Form 8-K, the company must provide the disclosure prescribed by the relevant Form 8-K item in its Form 10-Q or 10-QSB filed **for the quarter during which that event occurred**. [emphasis added].

The amendments to the relevant periodic reporting forms are consistent with the language in the first sentence of the above excerpt from the adopting release (e.g., indicating that the information to be disclosed would be that information required to be disclosed in a report on Form 8-K during the period covered by the report). The amendments to the periodic reporting forms do not make reference to date that the event occurred.

Committee Recommendation: The Committee supports View A. The Committee recognizes that one could read the language included in the respective forms as indicating that the due date of the Form 8-K should serve as the "reference point" for determining which periodic report's due date represents the close of the limited safe harbor period. However, the Committee notes that the clarifying language included in the text of the adopting release uses the event date as the "reference point" for determining which periodic report's due date represents to close of the safe harbor period.

Staff Response: The Staff takes View A.

Discussion Document I

Topic: Supplemental financial statements for a transaction accounted for in a manner similar to a pooling of interests

Facts: Company X is an SEC registrant and is owned 100% by Company Y. Company Y is not a public company. In June 2004, Company X consummates a transaction in which Company X acquires two affiliates that are owned 100% by Company Y. The transaction is accounted for as a combination of entities under common control, i.e., in a manner similar to a pooling of interests. The acquisition does not meet the significance threshold under Rule 3-05 of Regulation S-X.

Company X expects to file a registration statement with the SEC after the consummation of the transaction but before its second quarter financial statements reflecting the transaction are required to be filed. The registration statement will incorporate by reference Company X's audited financial statements for the three years ended December 31, 2003 and the unaudited financial statements for the quarter ended March 31, 2004.

Section II.A of Appendix C of the SEC's Staff Training Manual addresses presentation of supplemental financial statements for a transaction that would have previously been accounted for as a pooling of interests when post-consummation period results have not been published:

A. If post-consummation period results have not been published:

1. Financial statements giving effect to the pooling should be presented in transactional filings or in voluntary supplemental filings as "supplemental financial statements."
2. If the financial statements are required to be furnished in connection with an Exchange Act or Securities Act filing, the supplemental financial statements should:
   - Be audited,
   - Comply with Regulation S-X, and
   - Include an audit report dated subsequent to the consummation of the transaction but prior to publication of post-combination results.
3. Typically, supplemental financial statements are filed on an Item 5 Form 8-K. If the restated financial statements are furnished pursuant to the requirements of a registration statement or proxy, MD&A and applicable industry guide information should also be restated or expanded to provide necessary information about the combined entity.
4. Any registration statement made effective or proxy materials mailed prior to publication of post-combination financial information must include the

> audited historical financial statements of the registrant, without giving effect to the business combination. Presentation of audited supplemental financial statements restated for the pooling of interests does not satisfy the requirement to furnish the registrant's financial statements.

Section III provides the following guidance regarding timing of restating financial statements for business combinations accounted for in a manner similar to a pooling of interests:

> *III. Business Combination Accounted for in a Manner Similar to a Pooling of Interests*
>
> Consummation of a transaction accounted for in a manner similar to a pooling of interests, i.e., a reorganization of entities under common control, results in the restatement of the registrant's financial statements when the financial statements are issued for a period that includes the date the transaction was consummated.
>
> If a reorganization is consummated after a year-end balance sheet date but before that year-end Form 10-K is filed, the financial statements in the Form 10-K should not be restated to reflect the reorganization.

The SEC Staff Training Manual guidance for presenting supplemental audited financial statements giving effect to a pooling of interests is based on paragraph 61 of APB Opinion 16 (Opinion 16) which required that a combining company "disclose as supplemental information in notes to financial statement or otherwise, the substance of a combination consummated before financial statements are issued and the effects of the combination on reported financial position and results of operations." Statement of Financial Accounting Standards No. 141, "Business Combinations" (Statement 141) superceded Opinion 16 and, because poolings of interests are no longer appropriate under Statement 141, this guidance is no longer directly applicable. However, paragraphs D14 – D18 of Statement 141 indicate that certain provisions of Opinion 16 as they relate to the pooling method provide a source of continuing guidance on accounting for transactions between entities under common control. Paragraph D18 describes certain disclosures that should be provided when a transaction is accounted for in a manner similar to a pooling of interests. Paragraph D18 does not include the requirement for supplemental financial information set forth previously in paragraph 61 of Opinion 16.

Question: Is Company X required to include in the registration statement supplemental financial statements that combine Company X and the two affiliated companies in a manner similar to that described in Section II.A of Appendix C to the Staff Training Manual?

View A: Yes. The same information required historically for a transaction accounted for as a pooling of interests is required for a transaction accounted for in a manner similar to a pooling of interests. Even though Statement 141 does not carry forward the requirements of paragraph 61 of Opinion 16 the SEC intends for registrants to provide all of the same information for a transaction accounted for in a manner similar to a pooling of interests as would have been provided for a pooling of interests.

View B: No. Supplemental financial statements are not required. Statement 141 does not carry forward the requirement to provide the supplemental information specified in paragraph 61 of Opinion 16. A registrant need only provide the disclosures required by Paragraph D18 of Statement 141.

Committee Recommendation: The committee supports View A.

Staff Response: The Staff takes View A.

Discussion Document J

Topic: Potential Amendments by Companies that Identify Control Weaknesses When They First Implement Section 404 Reporting

Question: What amendments of prior filings should a company consider if, when it evaluates controls to provide its *first* management report on internal control over financial reporting, it identifies a material weakness?

Background: Beginning with periods ended on or after August 29, 2002, Item 307 of Regulation S-K has required public companies to evaluate and report on the effectiveness of their disclosure controls and procedures, and what is now Item 308(c) of Regulation S-K has required public companies to report material changes in internal control over financial reporting. Many of the controls that comprise a company's internal control over financial reporting are also elements of its disclosure controls and procedures.

Section 404 of the Sarbanes-Oxley Act, Exchange Act Rule 13a-15, and Item 308(a) of Regulation S-K require public companies to evaluate and report on the effectiveness of their internal control over financial reporting. This will first be required for annual reports for fiscal years ending on or after November 15, 2004 for accelerated filers and for years ending on or after July 15, 2005 for other filers.

Discussion: Since August 2002, companies that have identified material weaknesses in their internal control over financial reporting have had to consider the implications of those weaknesses when reporting on the effectiveness of their disclosure controls and procedures and when reporting changes in internal control. If the material weakness related to an element of internal control that was also an element of the company's disclosure controls and procedures, management has had to consider the need to modify its report on disclosure controls and procedures. Management has also needed to consider whether a material change in internal control over financial reporting had occurred that it needed to disclose. If management identified the material weakness after a periodic report had been filed (e.g., in connection with a restatement), it has needed to consider amending its previously filed reports on disclosure controls and procedures, its disclosures regarding material changes in internal control over financial reporting, or both.

In preparation for their first reports on internal control over financial reporting, companies are evaluating their internal controls. These evaluations may be more rigorous than the evaluations they performed when they evaluated elements of their internal control to provide their reports on disclosure controls and procedures. In addition, independent accountants will attest to management's report on internal control over financial reporting.

As a result of this more rigorous process, companies may identify material weaknesses in internal control over financial reporting that they had not previously identified. This will raise the question of whether prior Item 308(c) disclosures were incorrect. If the material weakness relates to a control element that is also part of a company's disclosure controls and procedures, this will raise the same question regarding prior Item 307 reports. However, it may not be possible to

pinpoint when the material weakness arose, so a company might have no way to objectively determine which report(s) to consider amending. Also, a company might suspect or believe that the material weakness existed in several previous periods and face the prospect of amending several reports.

In Question 9 of the SEC staff's FAQ, *Management's Report on Internal Control Over Financial Reporting and Disclosure in Exchange Act Periodic Reports*, the staff granted relief from the requirement to disclose changes in internal controls made in preparation for a registrant's first management report on internal control over financial reporting. Has the staff considered providing similar relief to registrants in the situation described above, i.e., where a material weakness in internal control over financial reporting is identified in connection with a registrant's first management report on internal control and fully disclosed in that report? What advice does the staff have for a company in the situations discussed above?

Committee Recommendation: In situations where (1) a material weakness is identified for the first time in the quarter in which management issues its first report on internal control over financial reporting (i.e. for a calendar year-end company, issuing its 12/31 report in the March 31 quarter) and disclosed in that report and (2) management had a reasonable basis for its prior reports on disclosure controls and procedures and its prior disclosures regarding changes in internal controls, we see little benefit to amending prior filings. We believe that amending prior filings would provide little additional useful information to investors. We also believe the need to consider amending prior filings will serve as a disincentive for people to honestly assess internal controls and admit to material weaknesses when they exist. We encourage the staff to strongly consider providing relief.

Staff Response: The Staff had not yet reached a final consensus as of the date of the joint meeting.

Discussion Document K

Topic: Reference to Standards of the Public Company Accounting Oversight Board (PCAOB) or Generally Accepted Auditing Standards (GAAS) in Certain Auditor Reports

Question: **What is the Staff's view on whether, in each of the following examples outlined below, the auditors' report should refer to the Public Company Accounting Oversight Board Standards or Generally Accepted Auditing Standards:**

1. Standard Broker-Dealer (B/D) Audit Report that is applicable to filings of B/D financial statements with the SEC and NASD for B/Ds that are not registrants - examples obtained from AICPA Audit and Accounting Guide for Broker Dealers

   Staff Response: GAAS– such an entity is not considered an issuer.

2. Audit of financial statements of life insurance company as the sponsor ('depositor' for Forms N-4 and N-6) of insurance separate accounts where the financial statements of the life insurance company are included along with the financial statements of the insurance separate account in Form N-3 (insurance separate accounts offering variable annuities registered as management investment companies), Form N-4 (insurance separate accounts offering variable annuities registered as unit investment trusts) and Form N-6

(insurance separate accounts offering variable life contracts registered as unit investment trusts). The financial statements of the life insurance company may, in certain circumstances, be statutory basis financial statements.

Staff Response: PCAOB – the entity is considered a co-issuer.

In a follow-up question regarding corporate governance and whether pre-approval by the audit committee of independent auditor services was required, the Staff stated that it would consider the question and inform the committee at a later date.

3. 17f-1 and 17f-2 Security Counts (Compliance Attestation) for Registered Investment Companies - examples obtained from AICPA Audit and Accounting Guide for Investment Companies (AICPA Guide)

   Staff Response: PCAOB – such an entity is considered an issuer

4. 206(4)-2 Security Count (Compliance Attestation) for Investment Advisers - examples obtained from AICPA Audit and Accounting Guide for Investment Companies

   Staff Response: GAAS – such an entity is considered a registrant but not an issuer

5. 17ad-13 reports for Transfer Agents - examples obtained from AICPA Audit and Accounting Guide for Investment Companies

   Staff Response: GAAS – such an entity is not considered an issuer

ATTACHMENT A

Reporting requirements under new 8-K rules relating to financial statements that should no longer be relied upon

Item 4.02, "Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review" of the Current Report on Form 8-K requires disclosure under Item 4.02 (a) if the "registrant's board of directors, a committee of the board of directors or the officer or officers…, concludes that any previously issued financial statements, covering one or more years or interim periods for which the registrant is required to provide financial statements under Regulation S-X… should no longer be relied upon because of an error in such financial statements…" In addition Item 4.02 (b) requires disclosure if "the registrant is advised or receives notice from**,** its independent accountants that disclosure should be made or action should be taken to prevent future reliance on a previously issued audit report or completed interim review related to previously issued financial statements…"

Paragraph 6 of AU Section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (AU 561), states in part: "When the auditor has concluded… that action should be taken to prevent future reliance on his report, he should advise his client to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to persons

who are known to be currently relying or who are likely to rely on the financial statements and the related auditor's report." Auditor advisement may be provided on an informal basis through discussions between the auditor and the registrant, or it may be provided in writing. Although the determination of what constitutes "appropriate" action and disclosure will depend on facts and circumstances, actions typically considered "appropriate" include the registrant issuing a press release (and now an Item 4.02(a) Form 8-K) indicating that the financial statements should no longer be relied on.

An auditor generally does not withdraw its report or publicly announce that the report cannot be relied upon provided the registrant has acted appropriately to prevent future reliance upon the affected financial statements to which the audit report relates. Rather, prior to the registrant making a public announcement that its financial statements should no longer be relied upon, the auditor typically discusses the matters with the registrant and assesses the conclusions that the registrant has reached and its proposed remedial action and determines whether the auditor concurs. If the registrant refuses to take "appropriate" action, AU 561.08 requires auditor notification to the client, regulatory agencies and others known to be relying on the financial statements.

The following implementation questions have arisen as it relates to the reporting requirements under Item 4.02(a) and 4.02(b) of the Current Report on Form 8-K:

1. Is an Item 4.02(a) 8-K required for <u>every</u> revision to a registrant's previously issued financial statements that is the result of an error?

<u>View A</u>

No. Paragraph 38 of APB 20 allows for the consideration of materiality in determining the treatment of an error. This same judgment should be applied to determine whether changes to the financial statements (e.g. for items such as additions of omitted disclosure, changes for typographical errors, changes in classification or gross/net presentation), result in the need to file an Item 4.02 8-K. If the independent registered public accounting firm determines or agrees that the revisions are not of such significance as to mandate that affirmative steps be taken to prevent reliance on the previously issued financial statements, then an Item 4.02 8-K would not need to be filed.

Supporters of View A believe that there is a rebuttable presumption that any restatement for the correction of an error is, by nature, material and results in a conclusion that the prior financial statements should not be relied upon, thus triggering the need to file an Item 4.02(a) 8-K. However this presumption can be overcome if the registrant and the independent registered public accounting firm conclude (based on a SAB 99 materiality assessment) that the prior financial statements may continue to be relied on. In this case, an Item 4.02(a) 8-K would not need to be filed.

For instance, in a situation where an error was immaterial to all prior periods, but its correction would be material to the current period and, therefore, may not be recorded as an out-of-period adjustment, such restatement of the prior financial statements would not **<u>automatically</u>** result in the conclusion that such prior financial statements (or the associated audit report or completed interim review) should not be relied on. This would be the case even if the independent registered public accounting firm makes reference to the error correction in its report and even if the restated financial statements reflect the disclosures required for error correction by SEC rules and APB 20.

View B

Yes. Every revision that is the result of a correction of an error should result in the filing of an Item 4.02 8-K.

Recommendation: The Committee supports View A.

SEC Staff response: The Staff supports View A, i.e., the Staff does not believe that an Item 4.02 Form 8-K is required for every revision to a registrant's previously issued financial statements that is the result of an error. However, the Staff would be "surprised" if amounts in the primary financial statements were changed due to an error, but an Item 4.02 Form 8-K was not filed. Furthermore, the Staff will likely question any situations in which previously issued financial statements are changed to correct an error (even if the change does not impact the primary financial statements) if there is no corresponding Item 4.02 Form 8-K filling. The Staff believes that a SAB 99 analysis would be necessary to determine whether an Item 4.02 Form 8-K should be filed.

With respect to the situation described in the third paragraph of View A, regarding an error that is immaterial to all prior periods, but whose cumulative effect is material to the current period and, therefore, cannot be recorded as an out-of-period adjustment, the Staff would not always agree that an Item 4.02 8-K is not necessary. As noted above, that conclusion would depend on the outcome of a SAB 99 materiality analysis.

Regarding the last paragraph of View A, the Staff commented that determination of the appropriate manner to adjust for a cumulative error should be based on specific facts and circumstances.

* * * * * * * * *

2. If the registrant has taken appropriate action to prevent reliance on the financial statements and has also filed an 8-K under Item 4.02(a), must the registrant also report under Item 4.02(b)?

View A

No. A registrant should report under Item 4.02(a) when it concludes that reliance should not be placed on previously issued financial statements because of an error in such financial statements. The registrant should report under Item 4.02(b) when the independent registered public accounting firm has notified the registrant in accordance with AU 561.06 that the auditor has concluded that action should be taken to prevent future reliance on a previously issued audit report or completed interim review. That is, when a registrant concludes that the financial statements should not be relied on, has made public disclosures to prevent future reliance on the financial statements in question and has reported under Item 4.02(a), it may not be necessary for the auditor to also notify the registrant that the auditor's report (or completed interim review) can no longer be relied on. If no such notification takes place, then disclosure under Item 4.02(b) is not required. However, if the auditor does make such notification or advisement to the registrant, then reporting under Item 4.02(b) in addition to Item 4.02(a) would be required.

Supporters of View A note that the rule proposal did not distinguish between Items 4.02(a) and 4.02(b). Rather this distinction was added in the final rule which states that "We have also separated the situation in which the company makes the determination internally regarding non-reliance on its financial statements from that in which the registrant's independent accountant

notifies the registrant of non-reliance on a previously issued audit report or completed interim review by including them in two different paragraphs to clarify the requirements of the item.

View B

Yes. Reporting under Item 4.02(b) is triggered when the auditor has both “concluded” on the matter and has notified/advised the registrant that action should be taken to prevent future reliance on the auditor’s report (e.g., under AU 561.06) or completed interim review. The method used to appropriately disclose newly discovered facts and their impact on the financial statements to persons who are known to be currently relying or who are likely to rely on the financial statements and the related auditor’s report is determined by facts and circumstances as specified in AU 561. If a registrant makes it known to the auditor that it intends to make timely and complete disclosure to the public of a correction of a material error in the application of GAAP it may obviate auditor notification/advisement (e.g., it would not be necessary for the auditor to submit formal notice of withdrawal of the auditor’s report). However advisement is implicit in that situation and this advisement is the functional equivalent of withdrawal of the auditor’s report.

Item 4.02(b) does not specify what type of advisement triggers Form 8-K disclosure so any situation in which the auditor concludes that action must be taken to prevent future reliance triggers the need for Item 4.02(b) disclosure. In practice, this would generally include all situations in which a registrant undertakes to correct a material GAAP error in its financial statements and the auditor agrees with that action.

In the event a registrant concludes that restatement of financial statements is necessary but the auditor does not believe the correction rises to the level that action must be taken to prevent future reliance on the auditor’s report, the registrant would file an Item 4.02(a) Form 8-K, but no Item 4.02(b) disclosure or Item 4.02(c) letter would be required.

View C

Yes. In all instances for which a registrant reports under Item 4.02(a), regardless of whether the auditor believes the correction rises to the level that action must be taken to prevent future reliance on the auditor’s report, the registrant must also report under Item 4.02(b) (and include the letter required by Item 4.02(c)).

Supporters of View C note that the independent registered public accounting firm’s agreement with a registrant’s decision to restate its financial statements to correct an error has the same effect as notification to the registrant that the prior audit report (or interim review) should no longer be relied on and therefore triggers the need to file under Item 4.02(b). Supporters of View C also note that each item in Form 8-K should be evaluated on its own to determine if the registrant has a disclosure responsibility. The mere fact that the registrant has satisfied its disclosure responsibilities under Item 4.02(a) does not mean that a disclosure obligation does not exist under Item 4.02(b).

Recommendation: The Committee supports View A. The Committee believes that when the registrant takes appropriate action to prevent future reliance on the financial statements that the issue of any separate reliance on the audit report (or completed interim review) becomes moot because the financial statements to which the audit report (or completed interim review) relates have been withdrawn, rendering the audit report (or completed interim review) meaningless. From a public policy perspective, the Committee believes that filings under Item 4.02(b) should be reserved for the limited, yet important, circumstances when the auditor has concluded that its audit report or completed interim

review should no longer be relied upon, but the registrant has either reached a different conclusion regarding the underlying financial statements or has not taken the appropriate action. The Committee believes that the impact of disclosure under Item 4.02(b) would be substantially diminished if it were to be the norm (e.g., Views B and C) rather than the exception (View A).

Staff response: The Staff supports View A, i.e, the Staff would not expect a 4.02(b) filing every time there is a 4.02(a) filing. The Staff believes that a registrant should report under Item 4.02(a) when it concludes that reliance should not be placed on previously issued financial statements because of an error in such financial statements, and should report under 4.02(b) when the independent registered public accounting firm has concluded and has notified/advised the registrant that action should be taken to prevent future reliance on the auditor's report (or completed interim review). In determining whether a filing is required under 4.02(b), the Staff acknowledges that an auditor advising a client to "consider" whether matters coming to the auditor's attention require revision to previously issued financial statements, is different than notifying the registrant that the auditor has "concluded" that steps should be taken to prevent future reliance on the auditor's report (or completed interim review). The Staff does not believe that an Item 4.02(b) 8-K is triggered by the former. However, the Staff emphasized that filing under 4.02(a) (without also filing under Item 4.02(b)) would be acceptable only if the registrant otherwise made the requisite disclosures required by paragraph AU 561.06 without the auditor first concluding and notifying/advising the registrant that its previously issued audit report (or completed interim review) should no longer be relied upon.

Recent Update
On November 23, 2004, the SEC issued a release entitled "Current Report on Form 8-K - Frequently Asked Questions." Question No. 23, which addresses the above topic, states the following:

Item 4.02 Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review

Question 23

Q: If a registrant has taken appropriate action to prevent reliance on the financial statements and has also filed a Form 8-K under Item 4.02(a), must the registrant file a second Form 8-K under Item 4.02(b) if it is separately advised by, or receives notice from, its auditor that the auditor has reached the same conclusion?

A: No. If the registrant has reported that reliance should not be placed on previously issued financial statements because of an error in such financial statements, the issuer does not need to file a second Form 8-K to indicate that the auditor has also concluded that future reliance should not be placed on its audit report, unless the auditor's conclusion relates to an error or matter different from that which triggered the registrant's filing under Item 4.02(a).