

**SEC REGULATIONS COMMITTEE**  
**Joint Meeting with SEC Staff**  
**September 16, 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.

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**I. ATTENDANCE**

A. SEC Regulations Committee

Jay Hartig, Chair  
Gerard Brinkman  
Jack Ciesielski  
Melanie Dolan  
David Follett  
Karin French  
John Gerdener  
Chris Holmes  
Jim Ledwith  
Jeff Lenz  
Scott Pohlman  
Ted Stalick  
Leonard Weinstock  
Tom Weirich  
John Wolfson

B. Securities and Exchange Commission

*Office of the Chief Accountant*

Scott Taub, Deputy Chief Accountant  
Jack Albert, Associate Chief Accountant  
Edmund Bailey, Assistant Chief Accountant  
Cathy Cole, Associate Chief Accountant  
Russell Hodge, Professional Accounting Fellow  
Mike Kigin, Associate Chief Accountant  
Shelly Luisi, Associate Chief Accountant  
Jane Poulin, Associate Chief Accountant  
Eric Schuppenhauer, Professional Accounting Fellow  
Marilyn Thaemert, Assistant Chief Accountant  
Kimberly Smith, Academic Accounting Fellow  
Eric West, Assistant Chief Accountant

*Division of Corporation Finance*

Carol Stacey, Chief Accountant  
Craig Olinger, Deputy Chief Accountant  
Louise Dorsey, Associate Chief Accountant  
Mary Greenawalt, Academic Fellow  
Todd Hardiman, Associate Chief Accountant  
Joel Levine, Associate Chief Accountant

*Division of Enforcement*

Susan Markel, Chief Accountant

*Division of Investment Management*

Adeel Jivraj, Assistant Chief Accountant

C. AICPA

Jennifer Roddy, SECPS  
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 personnel changes in OCA:

- Don Nicolaisen has been named the new Chief Accountant. He will be joining the SEC on October 1.
- OCA is continuing to hire additional staff. Five new staff members will join the SEC the week of September 22 and more candidates are being interviewed to fill open positions at the Associate and Assistant Chief Accountant levels. The ideal candidate for an Associate Chief Accountant position is a senior manager with extensive audit experience. Mr. Taub added that recent legislation has greatly improved the efficiency of the staff's hiring process.

### **B. Division of Corporation Finance**

Carol Stacey provided the following update of personnel changes in the Division of Corporation Finance:

- The Division is continuing its hiring efforts. The hiring function is now being handled by a hiring committee that is headed by James Daly and Carol Stacey.
- Two new Professional Accounting Fellows have recently started work in the Division.

### **C. Division of Enforcement**

Susan Markel provided the following update of personnel changes in the Division of Enforcement:

- Susan Markel has been named the Division's new Chief Accountant.
- Six new accountants have recently been hired and the Division has plans to hire six more in the near term. The ideal candidate has public accounting and/or private corporate finance experience at the manager level.

### **D. Chairman's Office**

Scott Taub noted that SEC Chairman Donaldson's executive office functions are administered by three executive managers: Laura Cox (public/government relations), Patrick Van Bargaen (policy issues) and Peter Derby (internal operations).

## **E. Professional Accounting Fellow (PAF) Program**

The PAF program is viewed by the Staff as a very beneficial program. The staff would like to increase the number of PAFs to eight by next summer.

## **III. STATUS UPDATES**

### **A. OCA Update**

*SAB 101 Update.* Scott Taub stated that the staff hopes to have the update of SAB No. 101 completed within a month. In the update, the staff (1) deleted all issues that are now covered by EITF Issue No. 00-21 and (2) incorporated applicable sections of the SAB 101 frequently asked questions (FAQ) document. The remainder of the SAB remains unchanged.

*FAQ on Independence.* On August 13, the staff released its FAQ document on the application of the January 2003 rules on auditor independence issues. The purpose of the FAQ is to clarify the staff's position on the application of the new independence rules to issues arising in practice.

*Off-Balance Sheet Arrangements Study.* Eric Schuppenhauer noted that the staff is working on a Sarbanes-Oxley mandated study of off-balance sheet arrangements that must be completed during 2004. While conducting the study, the staff may contact representatives of the accounting firm, analyst, and academic communities to gain additional insights and perspectives on off-balance sheet arrangements. Committee members indicated their willingness to assist the staff by providing background information.

*EITF Issue No. 00-21 Practice Issues.* The staff is primarily working on transition issues; no other major issues have arisen.

### **B. Division of Corporation Finance Update**

*Annual Reports – Fortune 1000 Reviews.* Carol Stacey noted that the staff is continuing its review of annual reports, with a focus on Fortune 1000 companies.

*MD&A Interpretive Release.* The staff is working on an interpretive release on MD&A disclosures with the hope of finalization this calendar year. The purpose of the release is to provide guidance to registrants that will assist in the formulation of more meaningful MD&A disclosures. If issued, the release would be effective for 2003 10-K MD&A disclosures and will cover a broad range of topics including a concentration on enhanced disclosure for the liquidity and cash flows section. The release will also recommend the

addition of a summary section to the MD&A and may include a discussion of common pitfalls/shortcomings noted by the Staff in their reviews of companies' MD&A disclosures included in Form 10-K.

*Updating Outlines.* The staff is working on updating the Division's three major outlines posted to the SEC website: *Current Issues and Rulemaking*, *Current Accounting and Disclosure Issues*, and *International Financial Reporting and Disclosure Issues*.

*Expanded 8-K Reporting Rulemaking.* The Office of Rulemaking is actively working on this rulemaking with the hopes of finalization in the near term. In addition to finalizing the rule, the staff needs to re-format EDGAR to accept the newly-created 8-K reporting items. Carol Stacey added that the staff considers this rulemaking an initiative under Section 409 of the Sarbanes-Oxley Act.

*Critical Accounting Policies (CAP) Rulemaking.* The staff will turn its attention to this proposal as soon as other rulemaking initiatives (such as 8-K reporting) are finalized. It is not likely that the final rules will be issued prior to year-end. Some of the concepts in the proposed CAP release, however, will be incorporated in the MD&A interpretive release.

*Securities Act Reform.* Division Director Alan Beller has indicated his interest in securities act reform. The extent and the timing of the proposed reforms, however, are uncertain at this time.

### **C. Division of Enforcement Update**

Susan Markel noted that the Enforcement Division has worked on more than 600 cases this year. Approximately 27% of the cases were financial reporting cases, many of which involved revenue recognition issues, asset overstatement and inadequate or improper disclosures. She also noted that the enforcement staff will investigate both companies *and individuals* that are involved in fraudulent activities. Any individual involved in perpetrating a financial fraud will be investigated, including those individuals outside the organization such as vendors or customers.

## **IV. CLASSIFICATION OF DERIVATIVE GAINS AND LOSSES IN THE INCOME STATEMENT**

Cathy Cole discussed a registrant matter involving an oil and gas company that had entered into financially settled commodity and interest related derivative contracts. The company was using these derivatives in what were referred to as "economic hedges." The derivatives were not designated as or did not qualify as hedges under FASB Statement No. 133. Changes in fair value of the economic hedges were classified in a single line item on the income statement captioned

"risk management activities." However, realized gains and losses, represented by the periodic or final cash settlements from those economic hedges, were reclassified in the period realized out of risk management activities and into revenue or expense lines associated with the related exposure. The registrant clearly disclosed this practice in the footnotes and included tabular reconciliations and roll-forwards of all derivative changes, amounts, and reclassifications.

The Staff does not believe that the presentation of unrealized gains and losses in one income statement line with reclassification of realized gains and losses to another line is appropriate. While Statement 133 is essentially "silent on geography," it was the clear intention of the FASB to eliminate the practice of synthetic instrument accounting. The Staff believes that the company's presentation was essentially a form of synthetic instrument accounting from an income statement perspective.

Further, Statement 133 is clear that any special accounting for derivatives requires special efforts. That standard only allows the fair value adjustment of a derivative to be split into various components within the context of applying specific hedge accounting models. Reclassifying realized gains and losses, as described, essentially presents hedge accounting-like results for some captions, without a registrant necessarily applying the rigors of hedge accounting.

The Staff asked the registrant to change its presentation in future filings. However, because the company was restating for another matter, the company changed its presentation of realized derivative gains and losses in its amended filing.

The Staff indicated that they are aware of this issue arising in more than one company and in more than one industry. This issue was added to the SEC Regulations Committee agenda in an attempt to communicate this position as quickly as possible to companies and their auditors.

## **V. OTHER-THAN-TEMPORARY (OTT) IMPAIRMENTS AT YEAR-END**

Carol Stacey indicated that the staff's approach to OTT impairments remains unchanged. If and when a consensus is reached in EITF Issue 03-01, companies will be expected to comply with that consensus. In the meantime, the staff will "ask lots of questions" and expect ample disclosures in situations where an investment has been underwater for a significant period of time with no recognition of an other than temporary impairment.

## **VI. METHODS OF COMMUNICATING STAFF POSITIONS**

Scott Taub stated that the staff is looking for ways to efficiently and effectively communicate staff positions. The staff's goal is to identify a central communication vehicle that is retrievable, searchable and constant. He asked the

Committee for recommendations or suggestions. Jay Hartig agreed to poll the Committee for ideas and provide them to the staff for consideration.

## **VII. CURRENT PRACTICE ISSUES**

### **A. Reporting the Correction of an Error in Financial Statements Included in Form 10-K**

**Background:** In September 2003, a calendar year registrant identifies a material error in the audited financial statements included in its 2002 Form 10-K. Unrelated to the error, in the first quarter of 2003, the registrant has consummated transactions (e.g. FAS 144 discontinued operations, reorganization of entities under common control, restatement of FAS 131 segment information) or adopted accounting principles retroactively that required the restatement of the 2002 interim financial statements included in the 2003 Form 10-Q's and will require the restatement of the 2002 and 2001 annual financial statements when they are included in the 2003 Form 10-K. The registrant has not filed a 1933 Act registration statement.

**Question:** In addition to amending the financial statements in the 2002 Form 10-K to correct the error, must the registrant also revise these financial statements to give effect to the transactions in 2003 that required revision of the 2002 interim financial statements included in the 2003 Form 10Q's?

#### **View A: No**

- The purpose of the Form 10-K/A is to correct the error and not update the financial statements for anything but the error. The second (dual) date on the auditor's report serves to confine the updating responsibility solely to the matters underlying the error. Proponents of View A recognize that an auditor has a responsibility to evaluate events occurring subsequent to the initial issuance of the financial statements for potential reporting implications. However, absent a transactional filing, proponents of View A do not believe it is necessary for the financial statements that are being revised to correct an error to be otherwise amended for other events that occur subsequent to the initial filing. Proponents of View A believe that this approach is consistent with 1934 Act regulations which permit a registrant to report these types of subsequent event transactions referred to above in a Form 8-K, rather than requiring the registrant to amend its previously filed Form 10-K, or otherwise requiring the previously filed historical financial statements to be revised for such events.

- If the financial statements were required to be updated in the Form 10-K/A for subsequent events/transactions other than the error correction, an extended period of time may be necessary to develop the information unrelated to the error which may deprive investors of a timely filing. Further, the notes to the financial statements would need to differentiate between the effect of the error correction on the previously filed financial statements and the effect of the revision relating to the other subsequent events being reflected in the amended financial statements.
- Possible analogy: Appendix C of the Staff Training Material (paragraph II.B.2 ) prohibits the inclusion of historical pooled financial statements in a Form 10-K that give effect to post-year end poolings.

**View B: Yes**

The 2002 financial statements are being reissued and should be current at the date of reissuance.

**Staff Position:**

Craig Olinger stated that the staff takes View A.

**B. Internal Control Reporting**

**Question 1:** Is internal control reporting (as well as reporting on disclosure controls and procedures) required in registration statements?

**Background and Discussion:** Securities Act and Exchange Act registration statement forms have not been amended to require the information called for by Items 307 or 308 of Regulations S-K and S-B. Therefore, a literal reading of the forms leads one to conclude that issuers are not required to report on disclosure controls and procedures or internal control over financial reporting in registration statements unless the form used requires the registrant to incorporate Exchange Act reports by reference.

**Staff Response:** Internal control reporting is not required in registration statements.

**Question 2:** Must benefit plans that file annual reports on Form 11-K provide a management report on internal control over financial reporting or an auditor's attestation report?

**Background and Discussion:** It appears that benefit plans that file annual reports on Form 11-K are subject to Exchange Act Rule 15d-15 and must maintain and evaluate internal control over financial reporting. However, it also appears that Form 11-K contains no instruction requiring plans to provide



a management report on internal control over financial reporting or an auditor's attestation report.

**Staff Response:** Form 11-K does not require a 302 certification. Although the rule is silent regarding Rule 404 reports in Form 11-K, the Staff has agreed that because Form 11-K filers are not subject to Item 308 of Regulation S-K, Form 11-K need not include a 404 report.

**Question 3:** Is internal control reporting (as well as reporting on disclosure controls and procedures) required in "glossy" annual reports that accompany or precede proxy statements pursuant to Exchange Act Rule 14a-3(b)?

**Background and Discussion:** Exchange Act Rule 14a-3 was not amended to require the information called for by Items 307 and 308 of Regulations S-K and S-B. Therefore, it appears that management reports on disclosure controls and procedures and internal control over financial reporting and auditor attestations regarding management reports on internal control over financial reporting are not required in glossy annual reports.

**Staff Response:** Internal control reports are not required in "glossy" annual reports.

**Question 4:** If a company first becomes an accelerated filer in its first fiscal year ending on or after June 15, 2004, must the company comply with the new requirements to evaluate and report on internal control over financial reporting in that same year?

**Background and Discussion:** Consider, for example, a June 30 year-end registrant that has been a registrant for several years. It did not meet the definition of an accelerated filer as of June 30, 2003, but it exceeded the \$75 million market float threshold for the first time on December 31, 2003. It appears that this company must file its June 30, 2004 Form 10-K on an accelerated basis and that this company must comply with the new requirements to evaluate and report on internal control over financial reporting in that Form 10-K. The rationale for this view is outlined below.

Release 33-8128 containing the accelerated filer rules indicates that the company in our example would have to file its June 30, 2004 Form 10-K on an accelerated basis. New Rule 12b-2(2) states (emphasis added):

The determination for whether a non-accelerated filer becomes an accelerated filer as of the end of the issuer's fiscal year governs the annual report to be filed for that fiscal year, the quarterly and annual reports to be filed for the subsequent fiscal year and all annual and quarterly reports to be filed thereafter while the issuer remains an accelerated filer.

The commentary on pages 17 – 18 (of 74) of the release explains this. It states (emphasis added):

A company that does not fall within the “accelerated filer” definition as of its first fiscal year ending on or after December 15, 2002 will have to re-evaluate its status at the end of each fiscal year. To address concerns raised by commenters, a company will determine its public float by looking back at the last business day of its most recently completed second fiscal quarter. This allows companies to know further in advance whether they will become an accelerated filer at the end of their fiscal year and allow them to begin making the appropriate preparations.

As explained in the new definition of “accelerated filer,” the determination of whether a non-accelerated filer becomes an accelerated filer as of the end of its fiscal year governs the annual report to be filed for that fiscal year, the quarterly reports to be filed for the subsequent fiscal year and annual and quarterly reports to be filed thereafter. Under the final rules, a company would not need to determine whether it would become an accelerated filer other than at the end of its fiscal year. We believe this provides increased notice to a company for planning purposes. It also lessens any potential confusion to investors by a sudden change in deadlines.

For example, if a calendar year-end company meets the public float requirement, but has not filed its first annual report as of December 31, 2002, it does not become an accelerated filer and remains subject to existing deadlines for its 2002 annual report and its 2003 quarterly reports. However, if on December 31, 2003, the company meets the public float test as of the last business day of its second fiscal quarter ending June 30, 2003 and meets the other requirements of the accelerated filer definition, the company becomes an accelerated filer subject to the accelerated deadlines for its 2003 annual report, 2004 quarterly reports and all periodic reports thereafter.

Since the company in our example would have to file its June 30, 2004 Form 10-K on an accelerated basis, it appears that it would be required to comply with the Section 404 internal control reporting requirements in that Form 10-K.

The Section 404 rulemaking release (Release 33-8238) states the following on page 2 (of 94) (emphasis added):

A company that is an “accelerated filer,” as defined in Exchange Act Rule 12b-2, as of the end of its first fiscal year ending on or after June 15, 2004,

must begin to comply with the management report on internal control over financial reporting disclosure requirements in its annual report for that fiscal year.

The release contains the same language on page 29.

**Staff Response:** Yes. A company that first becomes an accelerated filer in its first fiscal year ending on or after June 15, 2004, must comply with the new requirements to evaluate and report on internal control over financial reporting in that same year.

**Question 5:** How should a registrant evaluate and report changes in internal control during interim periods?

**Background and Discussion:** New Exchange Act Rules 13a-15(d) and 15d-15(d) and Item 308(c) of Regulations S-K and S-B require companies to evaluate changes in internal control over financial reporting each quarter and report changes that have materially affected, or are reasonably likely to materially affect, the registrant's internal control over financial reporting.

- a. How should a registrant "measure" a change in controls to decide whether it materially affects controls? Is a change material if there are merely significant differences in the techniques a company uses to achieve its control objectives? Does there need to be a change in the level of control effectiveness before a change is considered material? For example, if a significant change in the techniques a company uses to achieve its control objectives occurred (e.g., due to an acquisition or the installation of a new system) but the controls were judged to be effective before and after the change, is this a material change?

**Staff Position:** Obviously there is judgment is involved in making the determination. The rule was drafted in such a way that what has to be reported goes beyond just correcting problems. If material amounts have been spent on changing the internal control system that suggests a significant change. The staff will look at future 10-Qs to see how practice develops.

- b. When a material change is identified, what information about the change should a registrant provide? Item 308(c) simply tells a registrant to "disclose any change."

**Staff Position:** The specific disclosures depend on facts and circumstances. However, the company generally needs to describe the change, what the company did, and why and how they did it, i.e., disclose everything an investor may need to know about the change.

### C. Application of Accelerated Filing Deadlines to Registration Statements that Contain Acquired Business Financial Statements

**Background:** In the adopting release for the SEC's rule "Acceleration of Periodic Reporting Filing Dates and Disclosure Concerning Website Access to Reports" (Release No. 34-45741), the SEC Staff stated that they saw no significant reason to shorten the deadline for filing audited financial statements for acquired businesses. Therefore, no conforming amendments related to acquired business financial statements were adopted.

It is our understanding that reporting requirements for acquired businesses are intended to be completely unaffected by the accelerated filing rule, including the age of unaudited interim period financial statements under Rule 3-01 of Regulation S-X and the requirement under Rule 3-12 of Regulation S-X to update financial statements (except in the case where the acquired business is a reporting company that is also an accelerated filer under the new rule). We would like the SEC Staff to confirm our understanding. Also, it is our understanding that the accelerated filing requirements do not apply to target business financial statements included in a proxy or Form S-4 (unless the target is an accelerated filer). We would like confirmation of our understanding.

Given that acquired business financial statements are unaffected by the accelerated filing rule, differences may arise between the age of financial statements required for a registrant and the age of financial statements required for the acquired business in a registration statement. For example:

Calendar year end registrant is an accelerated filer and wants to have a registration statement declared effective August 10, 2004. The registration statement contains registrant audited financial statements for the three years ended December 31, 2003 and unaudited financial statements for the six months ended June 30, 2004 (August 10 is after the 40<sup>th</sup> day following quarter end). Registrant has a probable acquisition greater than 50% significant for which audited financial statements are required to be included under Rule 3-05 of Regulation S-X. For the acquired business audited financial statements for the three years ended December 31, 2003 and unaudited financial statements for the three months ended March 31, 2004 are required (the 135<sup>th</sup> day is August 13) to be included in the registration statement.

To address a similar type of age difference that can arise between domestic registrants and foreign acquired businesses, the SEC Staff previously published the following guidance in *Division of Corporation Finance: International Financial Reporting and Disclosure Issues*:

“Depending on the fiscal year ends of a domestic registrant and a foreign target company, application of the age of financial

statement rules may require the foreign target company to include a period in the pro forma information more current than its separate historical financial statements. Article 11 of Regulation S-X permits the ending date of the periods included for the target company to differ from those of the registrant by up to 93 days, and may provide sufficient relief. The staff also will consider combinations of periods that involve overlaps or gaps in the information of the target company of up to 93 days, provided that the resulting annual and interim periods are of the same length required for the registrant, and there are no overlaps or gaps in the registrant's information. However, the staff would not permit a registrant to omit an interim pro forma presentation because of different fiscal periods.”

**Question 1:** To avoid inconsistent periods being presented, must the registrant wait until the acquired business’ financial statements for the same period (in this case interim period ended June 30, 2004) are available before the registration statement can be declared effective? If so, it would result in *de facto* application of the new rule to acquired businesses and that appears not to be the intent of the SEC based on the discussion in the adopting release.

**Staff Response:** No. Rule 3-05 age requirements remain unchanged. There was no intent to create *de facto* application of the new rule to acquired businesses. Therefore, different periods may be presented for the registrant and the acquired business.

**Question 2:** If mismatched periods are presented, how should the pro forma information be prepared?

- a. Use the six months ended March 31, 2004 for the acquired business? This appears consistent with the 93-day recasting allowed under Rule 11-02)(c)(3) of Regulation S-X and the foreign guidance.
- b. Use the six months ended June 30, 2004? This would be consistent with Rule 11-02)(c)(3) of Regulation S-X and the foreign guidance but would result in somewhat of a *de facto* application of the accelerated filing rule to acquired businesses (although footnote information would not be required for the updated numbers).
- c. Use either a or b above

**Staff Response:** Either a or b would be acceptable. This applies to target companies in a Form S-4 as well.

## D. Calculating Significance of Equity Method Investees under Rule 1-02(w) of Regulation S-X Background

**Background.** For the purpose of measuring significance of equity method investees under Rule 3-09 of Regulation S-X registrants look to Rule 1-02(w) of Regulation S-X. The income test is:

“The registrant's and its other subsidiaries' equity in the income from continuing operations before income taxes, extraordinary items and cumulative effect of a change in accounting principle of the subsidiary exceeds 10 percent of such income of the registrant and its subsidiaries consolidated for the most recently completed fiscal year. “

The SEC Staff's Staff Training Manual (Topic Two, III.B.2) includes the following:

“For purposes of computing the income significance test under SX 3-09, use GAAP changes in the equity investment as presented in the income statement, which usually includes amortization of goodwill resulting from the registrant's equity investment and any writedown of the investment for impairment that is not otherwise reflected in the investee's financial statements.”

**Question 1.** For the purpose of measuring significance of equity method investees under Rule 3-09 of Regulation S-X, how should the numerator be determined?

1. Calculate the numerator as the equity method investee income pick up on a pretax basis at both the registrant and investee level. This approach would appear to be consistent with a literal reading of Rule 1-02(w).
2. Calculate the numerator as the equity method investee income pick up on an after tax basis at the investee level but prior to any registrant level income taxes. This approach appears consistent with Rule 5-03 of Regulation S-X income statement line items (i.e., Start with Line Item No. 14, *Income or loss from continuing operations*, and add to it Line Item No. 11, *Income taxes*). Line Items 12 and 13 are for minority interest and equity method earnings pick up, which are both presented on an after tax basis.
3. Calculate the numerator as the equity method investee income pick up on an after tax basis at both the registrant and investee level. This approach appears consistent with a literal reading of the SEC Staff Training Manual.

**Staff Position:** View 1. For purposes of S-X Rule 3-09 financial statement requirements and S-X Rule 4-08(g) summarized financial information, a

registrant must refer to the significance tests under Rule 1-02(w) of Regulation S-X. The "income test" is based on the registrant's "equity in the income from continuing operations before income taxes, extraordinary items and cumulative effect of a change in accounting principle" compared to "such income of the registrant and its subsidiaries consolidated for the most recently completed fiscal year." Such equity in an investee's pretax earnings is not otherwise shown or disclosed in the registrant's financial statements, so the amount to be used as the numerator in the test must be calculated.

The SEC staff expressed its view that the numerator of the income test for an equity investee should reflect the amount included in the registrant's income statement as equity earnings (1) adjusted for the registrant's share of income taxes recognized by the equity investee, (2) adjusted for the registrant's share of the investee's extraordinary items, cumulative effects of accounting changes and discontinued operations, if any and to the extent recognized in that line item, and (3) exclusive of any tax effects recognized by the registrant related to the equity investee (e.g., the tax effects of the amortization of equity method basis differences or any impairment of the equity method investment).

**Question 2:** For the denominator (or the numerator, if applicable), should the amount of extraordinary items and cumulative effect of a change in accounting principle included in the earnings from equity method investments pick-up be added back to consolidated income from continuing operations?

1. Yes, if the answer to Question 1 above is "1."
2. No, if the answer to Question 1 above is "2" or "3."

The SEC staff expressed its view that the denominator of the income test should reflect the amounts included in the registrant's income statement as income from continuing operations after adjustment to place (1) minority interest in income of consolidated subsidiaries and (2) equity in earnings of unconsolidated subsidiaries and 50 percent or less owned persons (i.e. all items similar to the numerator) on a basis that is consistent with the numerator. That is, adjustments should be made to the denominator for all items similar to those in the numerator to achieve an "apples to apples" calculation. (View 1).

#### **E. FIN 46 Practice Issues Addressed by Staff**

**Background:** Instruction 2 to Form 8-K defines acquisitions to include acquisition by lease, exchange, merger, consolidation, succession or other acquisition. An entity consolidated under FIN 46 could also meet the definition of a business under Article 11.

**Question 1:** Will the SEC require Item 2 Form 8-Ks and possibly S-X Rule 3-05 financial statements to report new consolidations under FIN 46 similar to newly acquired businesses or assets?

**Staff Response:** FIN 46 may have implications for Item 2 Form 8-Ks and financial statements required under S-X Rules 3-05, 3-09, and 3-10. The staff is in the process of considering these impacts and has not yet taken a position on the issue. If it is determined that financial statements under these articles of S-X are not required, the staff would still expect significant pro forma disclosure regarding the “would be” effects of consolidation. The extent of those disclosures could depend on the significance of the new consolidations and their impact on the financial statements.

**Question 2:** What other FIN 46 practice issues have been addressed by the staff?

Eric Schuppenhauer indicated that companies and their auditors should pay close attention to current FASB actions with regard to FIN 46. There will be a deferral of the effective date for some companies. Also, the SEC staff expects that companies and their auditors will reasonably apply the literature. There are a number of FSPs and a revision of the Interpretation in process. Where companies have taken a reasoned view, the Staff will not be enforcing a differing view until an FSP or the Revised Interpretation is finalized. The SEC staff also expects companies to make reasoned judgments and rather than defaulting to the most onerous view and then declaring that FIN 46 is nonoperational.