SEC REGULATIONS COMMITTEE
Joint Meeting with SEC Staff
September 25, 2002
SEC Headquarters - Washington, D.C.

HIGHLIGHTS

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

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

I. ATTENDANCE

A. SEC Regulations Committee

Jay Hartig, Chair
Jack Ciesielski
David Follett
John Gerdener
Chris Holmes
Gary Illiano
Jim Ledwith
Jeff Lenz
Scott Pohlman
Sam Ranzilla
Roy Van Brunt
Leonard Weinstock
Tom Weirich
John Wolfson

B. Securities and Exchange Commission

Office of the Chief Accountant

Robert Herdman, Chief Accountant
Scott Taub, Deputy Chief Accountant
Jack Albert, Associate Chief Accountant

Robert Burns, Associate Chief Accountant
Cathy Cole, Assistant Chief Accountant
Mike Kigin, Associate Chief Accountant
Jenifer Minke-Girard, Associate Chief Accountant
Jane Poulin, Associate Chief Accountant

Division of Corporation Finance

Craig Olinger, Deputy Chief Accountant
Todd Hardiman, Associate Chief Accountant
Leslie Overton, Associate Chief Accountant
Dave Smith, Academic Fellow

Division of Enforcement

Charles Niemeier, Chief Accountant

C. AICPA

Ian MacKay
Annette Schumacher Barr

II. PERSONNEL CHANGES

A. Office of the Chief Accountant (OCA)

Bob Herdman stated that Scott Taub has joined the Commission staff as a Deputy Chief Accountant in the Office of the Chief Accountant. He added that OCA will hire additional staff in the coming months to assist in the Commission's oversight of the newly formed Public Company Accounting Oversight Board (PCAOB).

B. Division of Corporation Finance (DCF)

Craig Olinger stated that Louise Dorsey has been named Associate Chief Accountant in the Division of Corporation Finance. In addition, Dave Smith has joined the DCF staff as an Academic Fellow.

C. Division of Enforcement

Charles Niemeier stated that the Division of Enforcement will hire fifteen additional enforcement accountants nationwide and will make more additions if appropriations are approved.

III. STATUS UPDATES

A. Critical Accounting Policies Proposal

Jenifer Minke-Girard stated that the staff has received 85 comment letters on the Commission's Critical Accounting Policy Proposal. The staff is in the process of reviewing the comments received. She added that most of the respondents were supportive of the proposal's objectives but thought the disclosure requirements were overwhelming. With regard to timing, the staff's goal is to issue final rules in time for 2002 10-Ks.

B. Supplemental Financial Information Proposal

The staff indicated final rules will not be issued this year.

C. Form 8-K Revisions Proposal

Craig Olinger stated that the staff has received approximately 80 comment letters on the Commission proposed revisions to Form 8-K. The staff is working to issue final rules as quickly as possible.

D. Fortune 500 Reviews

Craig Olinger reported that the staff is continuing its Fortune 500 reviews and is looking to complete all reviews this Fall. It was suggested that the staff share its observations at the SEC Conference in December.

E. Guide 3 Revisions

This project has been subsumed by immediate Sarbanes-Oxley implementation activities. As a result, no Guide 3 revisions are planned this year.

F. Enforcement Update

Charles Niemeier noted that the Division of Enforcement has opened approximately 180 financial fraud cases since January 1. In addition to the fact that a large number of cases were open, it is also important to note that the size of the cases is also significant, with high profile registrant and issues under focus. He added that a number of the investigations will close without any action, but because of the current environment the staff needs to make sure the appropriate reviews are made. Mr. Niemeier made the following additional observations:

- ✓ Criminal authorities are eager to get involved in financial fraud investigations and often won't wait for a referral from the staff to open a criminal investigation.

- ✓ Investigations are being completed quickly (for example, Dynegy and Homestore). This efficiency is due in part to coordination with/among the Office of the Chief Accountant, the Division of Corporation Finance and the Division of Enforcement.
- ✓ Companies that fully cooperate with the SEC in formal investigations may receive full relief from enforcement action. He pointed to the Commission's announcement that it would not bring any enforcement action against Homestore because of its swift, extensive and extraordinary cooperation in the Commission's investigation. Homestore's cooperation included reporting its discovery of possible misconduct to the Commission immediately upon the audit committee's learning of it, conducting a thorough and independent internal investigation, sharing the results of that investigation with the government (including not asserting any applicable privileges and protections with respect to written materials furnished to the Commission staff), terminating responsible wrongdoers, and implementing remedial actions designed to prevent the recurrence of fraudulent conduct. These actions, among others, significantly facilitated the Commission's expeditious investigation of this matter. (Complete details of the Homestore financial fraud case can be found on the SEC's website, Press Release No. 2002-141.)

IV. SAB 51 APPLICATION ISSUES

The staff discussed the application of SAB Topic 5-H (SABs 51 and 84) when the subsidiary is a partnership with multiple classes of equity. If the class of security issued by the subsidiary has a preference in distribution or liquidation rights over any other class of equity security (i.e., not possessing the characteristics of a residual equity interest, as in the case of common stock), the staff believes the transaction is not subject to SAB Topic 5-H. As such, there would be no "gain" on the transaction. The parent should reflect the proceeds from issuance as minority interest in its financial statements. The staff believes that if the class of security issued by the subsidiary has a preference in distribution or liquidation rights over any other class of equity security, then it is analogous to preferred stock. The staff refers to the response to Question 3 of SAB Topic 5-H, which clearly indicates that it is not appropriate to recognize a gain on the sale of securities other than common stock. That response states, "With respect to issuances of stock options, warrants, and convertible and other similar securities, gain should not be recognized before exercise or conversion into common stock, and then only provided that realization of the gain is reasonably assured at the time of such exercise or conversion."

V. CONTRACT ACCOUNTING FOR SERVICE CONTRACTS

The staff stated that questions have arisen regarding whether it would be appropriate to apply the percentage-of-completion method to service contracts. The staff points to SOP 81-1, *Accounting for Performance of Construction-Type* *and Certain Production-Type Contracts,* which clearly states that the percentage-of-completion method does not apply to service contracts. Bob Herdman stated that registrants that have reported results using the percentage-of-completion method that are substantially different than what should have been reported should come and talk with the staff. Craig Olinger added that from the viewpoint of the Division of Corporation Finance, registrants should adequately disclose all revenue recognition policies.

VI. ASSET RETIREMENT OBLIGATION (ARO) LIABILITY, FULL COST RULES, AND SFAS NOS. 143 AND 144

The Committee provided a brief status update of a document that will address issues relating to ARO liabilities, full cost rules and SFAS Nos. 143 and 144.

VII. FORWARD VERSUS SPOT PRICES FOR VALUING EMBEDDED FORWARDS IN RECEIVABLES ARISING FROM PRECIOUS METAL CONTRACTS

Apparently some mining companies have been using the spot price on the date of delivery of raw metals to processors to recognize revenue for provisionally-priced metals contracts. The final contract price is the spot price at a date representing the date on which refining/smelting is expected to be completed (such that the processor is not subject to price risk during that time). These mining companies would then reflect the change in the spot price until final settlement as an adjustment of the forward contract embedded in the receivable with the other side of the adjustment flowing through income. The SEC staff stated that the embedded forward should be bifurcated from the receivable host and that under SFAS 133 the appropriate price for valuing the forward is the forward rather than the spot price. Accordingly, revenue is recognized upon delivery based on the forward price for the expected settlement date, with fluctuations from the delivery date being reflected as derivative gains and losses.

VIII. SARBANES-OXLEY IMPLEMENTATION ISSUES

The staff noted that it expects to issue at least 25 rulemaking proposals relating to the implementation of the Sarbanes-Oxley Act. The Committee noted it will identify implementation issues related to the Act and will communicate the issues to the staff for consideration.

IX. RELIANCE ON PARAGRAPH 29 OF APB 20 IN AN IPO

A subsidiary of an SEC registrant that is being spun off to the parent's shareholders or sold to the public can apply the exception in paragraph 29 of APB Opinion 20 in its initial registration statement, as long as its standalone financial statements have not previously been publicly distributed. That is, the subsidiary may recast its financial statements to apply a principle different than that historically used in the parent's consolidated statements. As required by paragraph 30, the subsidiary must disclose the nature of the change in principle and justification for it, per paragraph 17. The subsidiary must "explain clearly why the newly adopted accounting principle is preferable."

The subsidiary cannot use paragraph 29 to retroactively reflect a change in estimate, or a change in estimate inseparable from a change in principle. Such changes should be reflected in the period in which they occur by both parent and subsidiary.

If the parent will continue to reflect the subsidiary in consolidation or on the equity method after the spin-off or sale, the parent must also change their accounting principle, obtain and file a preferability letter and reflect the change in principle using the normal method required by APB 20 (cumulative adjustment except in rare cases defined by APB20). It cannot use the paragraph 29 exception. This results in congruity between the reporting by the parent and the subsidiary/investee on a go-forward basis.

X. CONSENT ISSUE – REGISTRANTS REQUESTING GUARANTEE OF ISSUANCE OF CONSENT

Bob Herdman discussed the issue of registrants requesting assurance from their auditors in the annual engagement letters that the auditor will not refuse to render a consent at some undefined point in the future, after being terminated. He stated that he viewed such language in engagement letters to be a violation of independence rules.

XI CURRENT PRACTICE ISSUES

A. Reclassification required upon adoption of SFAS 145, Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections, for gains and losses from extinguishment of debt

Question: Should previously issued annual financial statements that are included in a registration or proxy statement be revised to reclassify any gain or loss on extinguishment of debt that was classified as an extraordinary item once a registrant adopts SFAS 145? Would the conclusion be different if the previously issued annual financial statements are incorporated by reference rather than included?

Background: Paragraph 10 of SFAS 145 indicates that:

"The provisions of this Statement related to the rescission of Statement 4 shall be applied in fiscal years beginning after May 15, 2002. Any gain or loss on extinguishment of debt that was classified as an extraordinary item in prior periods presented that does not meet the criteria in Opinion 30 for classification as an extraordinary item shall be reclassified. Early application of the provisions of this Statement related to the rescission of Statement 4 is encouraged."

For any period in which SFAS 145 is adopted, a registrant will likely be required to classify a gain or loss on extinguishment of debt as an ordinary item. Similar to reporting discontinued operations under SFAS 144, any gain or loss on extinguishment reported as an extraordinary item in prior year comparative financial information will have to be reclassified.

Discussion: There are several situations where GAAP requires restatement of previous period financial statements once a subsequent period's financial statements reflect the GAAP triggering event. These situations include: changes in segments under SFAS 131, Disclosures about Segments of an Enterprise and Related Information; discontinued operations under SFAS 144, Accounting for the Impairment or Disposal of Long-Lived Assets; initial adoption of SFAS 128, Earnings per Share; and transitional disclosures under SFAS 142, Goodwill and Other Intangibles. For changes in segments and discontinued operations reclassifications, the SEC staff has insisted on full restatement of annual financial statements to be included in a registration or proxy statement, once a registrant has filed subsequent interim period financial statements that reflect the change in segments or discontinued operations treatment. For initial adoption of SFAS 128 and SFAS 142, the staff provided accommodations for registrants incorporating financial statements by reference into new registration or proxy statements. In those situations, the SEC staff allowed registrants to avoid full restatement before filing the next year's Form 10-K if the registrants provided the information required by SFAS 128 or SFAS 142 for all periods presented in the registration or proxy statement in the filing itself (e.g., along with selected financial data) or in a Form 10-Q incorporated by reference.

The SEC staff has informally indicated that registrants that adopt SFAS 145 should restate annual financial statements included in registration or proxy statements. However, registrants may avail themselves of the same accommodations afforded initial adoption of SFAS 128 and SFAS 142 when financial statements are incorporated by reference in registration or proxy statements. That is, if registrants conclude that the financial statements do not require restatement and independent auditors will permit reissuance of their auditors' report without restatement, registrants can disclose the reclassifications in selected financial data included in a registration or proxy statement, or in a Form 10-Q incorporated by reference.

Related Issue

As it relates to former Andersen clients, will the SEC staff accept "reclassification treatment" to comply with SFAS 145 as inconsequential revisions under the new interpretation to AICPA, Professional Standards, vol. 1, AU Section 508, Reporting as Successor Auditor When Prior-Period Audited Financial Statements Were Audited by a Predecessor Auditor who has Ceased Operations? The reclassifications do not affect net income and the effect of reclassification is not pervasive, as is the case with discontinued operations.

The SEC staff indicated that the determination is the responsibility of the auditor and that the reclassification must involve no substantive audit work or judgment to be considered inconsequential.

B. Applicability of Change in Auditor Requirements to Foreign Registrants

Question: Should foreign registrants whose securities are registered with the SEC be subject to the same requirements relating to notification of auditor changes as domestic registrants?

Background: At the May 3, 2001 meeting, the International Practice Task Force discussed the applicability of the requirements relating to notification of changes in the auditor of a foreign registrant given that foreign registrants do not file 8-Ks and Item 304 of Regulation S-K does not apply to foreign registrants. The Task Force agreed that there is no reason for a distinction between domestic and foreign registrants with respect to the need for or content of the disclosure called for by Item 304 of Regulation S-K. However, the Task Force also agreed that it would not be appropriate to modify the concepts that require the timing and content of information included in a Form 6-K. Accordingly, the Task Force would be in favor of a rule change whereby the disclosure required by Item 304 of Regulation S-K would be included in the annual report on Form 20-F with respect to filings under the 1934 Act and the disclosures would be the same as a domestic issuer in filings under the 1933 Act. The Task Force recommended that this issue be discussed with the SECPS to obtain their support for encouraging the SEC to extend the Item 304 disclosure to foreign registrants in the manner discussed. The SEC would need to undertake rule making in relation to any change.

In addition, the NYSE requires a listed company to notify the market about a change in auditors. Such notification would be required to be filed under cover of a Form 6-K, but would not necessarily include all the information about the circumstances of the change that are required to be included in a Form 8-K.

The SEC staff agreed that any change to extend the Item 304 disclosures to foreign registrants would require rulemaking and could be included in certain future rule proposals.

C. Application of Rule 3-10 in Interim and Annual Periods

Questions: Should the ongoing assessment of whether a non-guarantor subsidiary is minor be performed at each interim and annual period or on an annual basis only? Once a non-guarantor subsidiary becomes greater than minor, for what periods are condensed consolidating financial information required to be presented? Should a registrant provide condensed consolidating financial information when a previously minor non-guarantor subsidiary becomes greater than minor in the current interim period but is expected to be minor again by year-end?

Background: Rule 3-10 requires that each subsidiary issuer or guarantor file the same financial statements specified by Regulation S-X for a registrant, except under certain circumstances when condensed consolidating financial information is permitted or in certain limited cases when narrative disclosure about the guarantees is permitted in lieu of condensed consolidating financial information. An example is a parent company issuer with no independent assets or operations where all direct and indirect subsidiaries included in the parent company's consolidated financial statements, other than minor subsidiaries, are guarantors on a full and unconditional and joint and several basis. A subsidiary is considered minor if each of its total assets, stockholders' equity, revenues, income from continuing operations before income taxes, and cash flows from operating activities is less than 3% of the corresponding consolidated amount.

Discussion: It is not clear how a registrant should apply Rule 3-10 in the interim and annual periods subsequent to the issuance of a registered security that is guaranteed.

<u>Interim or Annual Test</u> – Narrative disclosure in lieu of condensed consolidating financial information is permitted only if non-guarantor subsidiaries are minor. Rule 3-10 is silent on how often a registrant should assess the materiality of non-guarantor subsidiaries. Should the assessment be performed at each interim and annual period or on an annual basis only?

View A – Assessment should be performed at each interim and annual period.

View B – Assessment should be performed on an annual basis only.

Craig Olinger indicated the staff would take View A, because compliance with the conditions in Rule 12h-5 must be met at each reporting date to maintain the subsidiaries' exemptions from filing separate annual and quarterly reports.

<u>Periods for Which Information is Required</u> – Once a non-guarantor subsidiary is identified as being greater than minor, condensed consolidating financial information is required to be provided. Should the required financial information be provided for all periods presented in the parent company's financial statements (including prior periods when the non-guarantor subsidiary was minor) or should the financial information be provided only for the current period in which the subsidiary becomes greater than minor and prospective periods?

View A – Condensed consolidating financial information should be provided for all periods presented in the parent company's financial statements, including prior periods when the non-guarantor subsidiary was minor. For example, the information should be provided for all three years presented in a Form 10-K even though the non-guarantor subsidiary was minor in the first two years presented.

View B – Condensed consolidating financial information should be provided for the current period in which the non-guarantor subsidiary becomes more than minor and prospective periods only.

Craig Olinger indicated that the staff would take View B.

Change in Status of Non-Guarantor Subsidiary – A literal interpretation of Rule 3-10 appears to require the presentation of condensed consolidating financial information in all situations where a non-guarantor subsidiary is greater than minor, even if the previously minor subsidiary is greater than minor for the first time in the interim period and is expected to be minor again by year-end. Is this view appropriate, or should the application of Rule 3-10 be modified in such situations?

View A – Condensed consolidating financial information should be provided in all situations where a non-guarantor subsidiary is greater than minor, even if such information is not expected to be required in future periods.

View B – If a non-guarantor subsidiary is greater than minor in the current period, but is expected to be minor in future periods, presentation of narrative disclosure in lieu of condensed consolidating financial information is permitted.

Craig Olinger indicated that the staff would take View A unless there were unusual facts and circumstances, in which case they should be discussed with the staff in advance.