Title: Current Accounting and Disclosure Issues in the Division of Corporation Finance

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Current Accounting and Disclosure Issues  
in the Division of Corporation Finance  

November 30, 2006

I. Recent Rules, Proposed Rules, Interpretive Bulletins, and Other Commission Activity

A. Final Rules Regarding Executive Compensation (New)

On July 26, 2006, the Commission voted to adopt changes to the rules requiring disclosure of executive and director compensation, related person transactions, director independence and other corporate governance matters, and security ownership of officers and directors (see Release No. 33-8732A). These changes affect disclosure in proxy statements, annual reports and registration statements, as well as the current reporting of compensation arrangements. The rules require that most of this disclosure be provided in plain English. The principal areas of the release are summarized below.

Executive and Director Compensation

The amendments will refine the existing tabular disclosure and combine it with improved narrative disclosure to elicit clearer and more complete disclosure of compensation of the principal executive officer, principal financial officer, the three other highest paid executive officers and the directors.

- A Compensation Discussion and Analysis addresses the objectives and implementation of executive compensation programs – focusing on the most important factors underlying each company’s compensation policies and decisions.
  - The Compensation Discussion and Analysis is filed and thus is a part of the disclosure subject to certification by a company’s principal executive officer and principal financial officer.
  - A new furnished Compensation Committee Report requires a statement of whether the compensation committee has reviewed and discussed the Compensation Discussion and Analysis with management and, based on this review and discussion, recommended that it be included in the company’s annual report on Form 10-K and proxy statement.
  - The Performance Graph is retained, but no longer coupled with executive compensation disclosure. The requirement for the Performance Graph is moved to the disclosure rule covering the market price of common equity and related matters, and the Performance Graph is required in annual reports to security holders that accompany or precede proxy statements relating to annual meetings at which directors are to be elected.
Following the Compensation Discussion and Analysis section, executive compensation disclosure is organized into three broad categories: compensation over the last three years; holdings of outstanding equity-related interests received as compensation that are the source of future gains; and retirement plans, deferred compensation and other post-employment payments and benefits.

- Tabular and narrative disclosure:
  - Summary Compensation Table – tabular disclosure of the compensation for each named executive officer over the last three years. The table is accompanied by narrative disclosure and a Grants of Plan-Based Awards Table that explains the compensation information presented in the table.
- Outstanding equity interests disclosure:
  - The Outstanding Equity Awards at Fiscal-Year End Table - outstanding awards representing potential amounts that may be received in the future, including the amount of securities underlying exercisable and unexercisable options, the exercise prices and the expiration dates for each outstanding option.
  - The Option Exercises and Stock Vested Table - amounts realized on equity compensation during the last fiscal year.
- Retirement plan and post-employment disclosure:
  - The Pension Benefits Table - actuarial present value of each named executive officer’s accumulated benefit under each pension plan.
  - The Nonqualified Deferred Compensation Table – executive contributions to nonqualified deferred compensation plans, company contributions, withdrawals, all earnings for the year (not just the above-market or preferential portion) and the year-end balance.
  - A narrative description of any arrangement that provides for payments or benefits at, following, or in connection with any termination of a named executive officer, a change in responsibilities, or a change in control of the company, including quantification of these potential payments and benefits assuming that the triggering event took place on the last business day of the company’s last fiscal year and the price per share was the closing market price on that date.

**Director Compensation**

The amendments require disclosure of director compensation for the last fiscal year in a Director Compensation Table (along with related narrative), which is similar in format to the Summary Compensation Table described above.

**Related Person Transactions, Director Independence and Other Corporate Governance Matters**
The amendments streamline and modernize the related person transaction disclosure, including:

- Increasing the dollar threshold for transactions required to be disclosed from $60,000 to $120,000,
- Requiring disclosure of a company’s policies and procedures for the review, approval or ratification of related person transactions,
- Eliminating the distinction between indebtedness and other types of related person transactions, and eliminating requirements for disclosure of specific types of director relationships, and
- Specifying exceptions for some categories of transactions that do not fall within the principle for disclosure under the related person transaction disclosure requirement.

New Item 407 of Regulations S-K and S-B consolidates existing disclosure requirements regarding director independence and related corporate governance matters, in most cases without substantive change, while updating disclosure requirements regarding director independence to reflect the Commission’s current requirements and current listing standards. The disclosure under this requirement includes:

- Disclosure of whether each director and director nominee is independent,
- A description, by specific category or type, of any transactions, relationships or arrangements not disclosed as a related person transaction that were considered by the board of directors when determining if applicable independence standards were satisfied,
- Disclosure of any audit, nominating and compensation committee members who are not independent, and
- Disclosure about the compensation committee’s processes and procedures for the consideration of executive and director compensation.

Security Ownership of Officers and Directors

The amendments require disclosure of the number of shares pledged by management, and the inclusion of directors’ qualifying shares in the total amount of securities owned.

Form 8-K

The rules modify the disclosure requirements in Form 8-K to capture employment arrangements and material amendments only for named executive officers. The rules also consolidate all Form 8-K disclosure regarding employment arrangements under a single item.

Effective Dates
The rules are effective as follows.

- For Forms 8-K, effective for triggering events that occur on or after November 7, 2006,
- For Forms 10-K and 10-KSB, effective for fiscal years ending on or after December 15, 2006,
- For proxy and information statements covering registrants other than registered investment companies, effective for any new proxy or information statements filed on or after December 15, 2006, that are required to include Item 402 and 404 disclosure for fiscal years ending on or after December 15, 2006, and
- For Securities Act registration statements covering registrants other than registered investment companies and Exchange Act registration statements (including pre-effective and post-effective amendments, as applicable), effective for registration statements that are filed with the Commission on or after December 15, 2006, that are required to include Item 402 and 404 disclosure for fiscal years ending on or after December 15, 2006.

B. Employee Stock Options

1. Staff Letter Summarizing Views Regarding Accounting for Stock Options (New)

On September 19, 2006, the Commission’s Office of the Chief Accountant issued a letter summarizing the staff’s views regarding the accounting for stock options in the historical financial statements of public companies. The letter discusses the accounting consequences under Accounting Principles Board Opinion No. 25, “Accounting for Stock Issued to Employees” of dating an option award to predate the actual award date, option grants with administrative delays, uncertainty as to the validity of prior grants, and other related circumstances. The letter can be accessed on the SEC’s website at the following link: http://www.sec.gov/info/accountants/staffletters/fei_aicpa091906.htm.

2. Staff Accounting Bulletin 107

On March 29, 2005, the Commission’s Office of the Chief Accountant and Division of Corporation Finance released Staff Accounting Bulletin No. 107, “Share-Based Payment” (SAB 107), relating to the FASB accounting standard for stock options and other share-based payments. The interpretations in SAB 107 express views of the SEC staff regarding the application of SFAS 123R. Among other things, SAB 107 provides interpretive guidance related to the interaction between SFAS 123R and certain SEC rules and regulations, provides the staff’s views regarding the valuation of share-based payment arrangements for public companies, and reminds public companies of the importance of including disclosures within filings made with the SEC relating to the accounting for share-based payment transactions, particularly during the transition to SFAS 123R.
In particular, SAB 107 provides guidance on the following:

- share-based payment transactions with nonemployees;
- transition from nonpublic to public entity status;
- valuation methods (including assumptions such as expected volatility and expected term);
- accounting for certain redeemable financial instruments issued under share-based payment arrangements;
- classification of compensation expense;
- non-GAAP financial measures;
- first-time adoption of SFAS 123R in an interim period;
- capitalization of compensation cost related to share-based payment arrangements;
- accounting for income tax effects of share-based payment arrangements upon adoption of SFAS 123R;
- modification of employee share options prior to adoption of SFAS 123R; and
- disclosures in Management’s Discussion and Analysis (MD&A) subsequent to adoption of SFAS 123R.

The adoption of SFAS 123R may result in significant differences between the financial statements of periods before and after the adoption. Therefore, it is imperative that disclosure in MD&A and the financial statements assist investors in understanding the impact of the adoption of SFAS 123R, including the impact on the comparability of financial statements from period to period. As SAB 107 points out, this disclosure should be quantitative as well as qualitative. Section F of SAB 107 discusses ways that registrants could disclose the effect of share-based payment arrangements on individual line items in the financial statements. Disclosure of the amount of expense might be appropriate in a parenthetical note to the appropriate income statement line items, on the cash flow statement, in the footnotes to the financial statements, or within MD&A. Registrants should avoid presentations on the face of the financial statements that give the impression that the nature of the expense related to share-based compensation is different from cash compensation paid to the same employees (for example by creating one or more separate line items for share-based compensation or by adding a table totaling the amount of share-based compensation included in various line item).

3. **Valuation of Employee Stock Options**

On September 9, 2005, the Commission’s Chairman and Chief Accountant each released a statement regarding the staff’s evaluation of proposals to use newly created market instruments to value employee stock options for financial reporting purposes. The different strategies proposed involve the use of market instruments to estimate the grant-date fair value of employee stock options, including attempts to design instruments that could be sold into the market at a value intended to be reasonably equivalent to the fair value of employee stock options.

Analysis also provided their views in a memo which provides a fuller understanding of the issues, available at: http://www.sec.gov/news/extra/memo083105.htm.

C. Quantifying Misstatements (New)

On September 13, 2006, the Commission’s Office of the Chief Accountant and Divisions of Corporation Finance and Investment Management released Staff Accounting Bulletin No. 108, “Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements”, providing interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement.

There have been two common approaches used to quantify such errors. Under one approach, the error is quantified as the amount by which the current year income statement is misstated. The other common approach quantifies the error as the cumulative amount by which the current year balance sheet is misstated. Exclusive reliance on an income statement approach can result in a registrant accumulating errors on the balance sheet that may not have been material to any individual income statement, but which nonetheless, may misstate one or more balance sheet accounts. Similarly, exclusive reliance on a balance sheet approach can result in a registrant disregarding the effects of errors in the current year income statement that result from the correction of an error existing in previously issued financial statements.

The staff believes that registrants should quantify errors using both a balance sheet and an income statement approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. The SAB states that the staff will not object if a registrant records a one-time cumulative effect adjustment to correct errors existing in prior years that previously had been considered immaterial – quantitatively and qualitatively - based on appropriate use of the registrant’s previous approach. The SAB describes the circumstances where this would be appropriate as well as the required disclosures to investors.

SAB 108 can be found at http://www.sec.gov/interps/account/sab108.pdf.

D. Final Rules Regarding Use of Form S-8, Form 8-K, and Form 20-F by Public Shell Companies (Updated)

On June 29, 2005, the Commission voted to adopt rules and amendments to assure that investors in shell companies that acquire operations or assets have access on a timely basis to the same kind of information as is available to investors in public companies with continuing operations (see Release No. 33-8587). The rules are intended to protect investors by deterring fraud and abuse in the securities markets through the use of shell companies.

The new rules and amendments relate to the use of Form S-8, Form 8-K, and Form 20-F by public shell companies. The changes:
• define the term "shell company" to mean a registrant, other than an asset-backed issuer, that has no or nominal operations, and either:
  o no or nominal assets;
  o assets consisting solely of cash and cash equivalents; or
  o assets consisting of any amount of cash and cash equivalents and nominal other assets;
• revise the definition of "succession" to include a method of taking a private company public through a shell company that is known as the "back door" Exchange Act registration procedure;
• prohibit the use of Form S-8 by shell companies;
• permit former shell companies to use Form S-8 once they become operating companies and 60 days have passed since they filed with the Commission the information about the operating company that they would be required to provide if they were filing a registration statement under the Exchange Act;
• add new Form 8-K Item 5.06 to require disclosure when companies cease to be shell companies;
• revise the existing Form 8-K items relating to acquisition or disposition of assets and changes in control to require companies that cease being shell companies, within four business days of the transaction, to disclose information comparable to the information that they would be required to provide if they were filing an Exchange Act registration statement;
• require foreign private issuer shell companies to report transactions that cause them to cease being shell companies on Form 20-F, providing disclosure comparable to that which domestic companies will report on Form 8-K; and
• require companies to indicate on the cover page of their Exchange Act periodic reports whether they fall within the definition of "shell company."

The amendments to Form 8-K require the surviving entity in a transaction where a shell company ceases being a shell company to make a more specific and detailed filing upon completion of such a transaction that is required to be reported on that form. These transactions will fall within the requirements of either or both of Item 2.01 and Item 5.01 of Form 8-K. Upon completion of this type of transaction, the surviving entity will be required to file a current report on Form 8-K containing the information, including financial information, that would be required in a registration statement on Form 10 or Form 10-SB to register a class of securities under Section 12 of the Exchange Act, with that information reflecting the surviving entity and its securities upon consummation of the transaction. The financial statements of the operating company that are required by Item 2.01 of Form 8-K should be audited in accordance with PCAOB standards as the operating company is the predecessor to the registrant shell company.

The amendments took effect on August 22, 2005, except for new Form 8-K Item 5.06, which took effect on November 7, 2005.
E. **Rules and Concept Release Regarding the Use of Tagged Data and Incentives to Voluntarily Submit XBRL Information (Updated)**

Data tagging is gaining prominence as a format for enhancing financial reporting data using eXtensible Mark-Up Language (XML) derivatives, such as XBRL. Tagging provides greater context to data through standard definitions that turn text-based information, such as the filings currently contained in the Commission’s EDGAR system, into documents that can be retrieved, searched and analyzed through automated means. Data tags describe information such as items included in financial statements. This enables investors and other marketplace participants to analyze data from different sources and allows for the automatic exchange of financial information across various software platforms, including web services.

On January 11, 2006, the Commission announced that the Commission staff will offer expedited reviews of registration statements and annual reports to companies that volunteer for a test group as part of the Commission’s interactive data initiative. The Commission first began a voluntary program for receiving financial information using XBRL in April 2005 (see Release No. 33-8529). This program allows for the voluntary submission of XBRL documents as exhibits to periodic and current reports from corporate issuers and Investment Company Act reports.

Companies that participate in the voluntary program’s new test group will furnish financial data contained in their periodic and investment company reports in XBRL format for at least one year and provide feedback on their experiences, including the costs and benefits associated with reporting in the interactive data format. Because of the efficiencies staff anticipates in reviewing their filings prepared in XBRL and to encourage participation in the test group, the Commission staff will offer volunteers expedited reviews of registration statements under the Securities Act of 1933 that the staff has selected for review. For well-known seasoned issuers, the Division of Corporation Finance staff will offer to inform volunteers whether or not the staff will select their annual reports on Form 10-K for review. The staff will notify each well-known seasoned issuer volunteer whether it will select the volunteer's Form 10-K for review within 30 days after filing and will undertake to provide any comments on that filing within 45-60 days of filing.

The Commission staff is seeking test group participants that will use the commercial and industrial, banking, insurance, or investment management industry classifications in XBRL. Companies interested in participating in the test group should contact Jeffrey Naumann in the Office of the Chief Accountant (naumannj@sec.gov) or Brigitte Lippmann in the Division of Corporation Finance (lippmannb@sec.gov) for more information.

On September 25, 2006, the Commission announced the awarding of three separate contracts totaling $54 million to begin the transformation of the agency’s public company disclosure system from a form-based electronic filing cabinet to a dynamic real-time search tool with interactive capabilities. The contracts awarded are intended to modernize and maintain the Commission’s EDGAR database; to complete the writing of XBRL “taxonomies,” or computer labels, so that companies in all industries can file their financial reports; and to provide a new generation of “interactive” investor tools on the SEC’s website.
On November 14, 2006, the Commission announced the introduction of a new full-text search tool on the Commission's website, enabling investors to search the contents of the disclosure documents filed electronically with the SEC. The newly searchable information includes registration statements, annual and quarterly reports, and other filings by companies and mutual funds filed during the past four years on the Commission's EDGAR database. A full text search of a filing includes all data in the filing as well as any attachments. The EDGAR full-text search tool is available on the SEC website at http://searchwww.sec.gov/EDGARFSClient/jsp/EDGAR_MainAccess.jsp. The Commission plans further enhancements based on user feedback. Requests, comments and suggestions should be sent to textsearch@sec.gov. Other features of the EDGAR Full-Text Search tool include:

- Search by specific filing type
- Search by company name
- Search by Central Index Key (CIK) code
- Search by industry or Standard Industrial Classification (SIC) code
- Search results limited by date range.

On September 27, 2004, the same day the Commission issued the proposing release to establish the voluntary program to allow XBRL information to be filed, the Commission also issued a concept release, Release No. 33-8497. The concept release seeks public comment on the benefits of tagging data to improve reporting quality and efficiency, the implications of tagging data for filers, investors, the Commission and other market participants, and the adequacy and efficacy of XBRL as a format for reporting financial information.

On October 3, 2006 and June 12, 2006, the Commission held Interactive Data Roundtables to discuss ways that interactive data can improve disclosure for investors. Additional information on the Commission’s tagged data and XBRL initiatives, including transcripts and other information on the roundtable, can be found at http://www.sec.gov/spotlight/xbrl.htm.

F. Accelerated Filer Definitions and Deadlines for Filing Periodic Reports (Updated)

1. Summary of Requirements

On September 5, 2002, the Commission adopted final rules requiring that every registrant meeting the definition of “accelerated filer” in Exchange Act Rule 12b-2 to file its annual report on Form 10-K and its quarterly reports on Form 10-Q on an accelerated basis. The changes for these accelerated filers were to be phased-in, originally paring down the due dates from 90 to 60 days after the end of the fiscal year for 10-Ks and from 45 to 35 days after the end of the first, second and third fiscal quarters for 10-Qs.
The Commission voted in November 2004 to postpone the final phase-in period for acceleration of periodic report filing dates (see Release No. 33-8507). As a result, for an additional year the deadline for accelerated filers remained at 75 days after year end for annual reports and at 40 days after quarter end for quarterly reports.

The Commission voted in December 2005 to adopt amendments to the periodic report filing deadlines and the Exchange Act Rule 12b-2 definition of an “accelerated filer” (see Release No. 33-8644). The amendments create a new category of filers, “large accelerated filers,” for companies that have a public float of $700 million or more and meet the same other conditions that apply to accelerated filers. The amendments also redefine “accelerated filers” as companies that have at least $75 million but less than $700 million in public float. Under the amendments, the deadlines for large accelerated filers and accelerated filers are as follows:

<table>
<thead>
<tr>
<th>Category of Filer</th>
<th>Form 10-K Deadline</th>
<th>Form 10-Q Deadline</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large Accelerated Filer</td>
<td>75 days for fiscal years ending before Dec. 15, 2006 and 60 days for fiscal years ending after Dec. 15, 2006</td>
<td>40 days</td>
</tr>
<tr>
<td>Accelerated Filer</td>
<td>75 days</td>
<td>40 days</td>
</tr>
<tr>
<td>Non-accelerated Filer</td>
<td>90 days (same for Form 10-KSB)</td>
<td>45 days (same for Form 10-QSB)</td>
</tr>
</tbody>
</table>

The amendments also modify the procedures by which accelerated filers can exit accelerated filer status by permitting an accelerated filer whose public float has dropped below $50 million to file an annual report on a non-accelerated basis for the same fiscal year that the determination of public float is made. The amendments similarly permit a large accelerated filer to promptly exit large accelerated filer status once its public float has dropped below $500 million.

Foreign private issuers filing on Forms 20-F or 40-F are not subject to the new rules. However, a foreign private issuer electing to file on Forms 10-K and 10-Q in lieu of Form 20-F or 40-F will be subject to the large accelerated filing and accelerated filing rule if it meets the respective definition.

Rule 12b-25 permits registrants an extension of time in which to file their Forms 10-K and 10-Q and still be considered to have filed those reports timely. The new rules do not change the 15 calendar day period (for Form 10-K) and 5 calendar day period (for Form 10-Q) provided for under Rule 12b-25.

Large accelerated filers and accelerated filers can file their Article 12 financial statement schedules by amendment within 30 days following the due date of their Form 10-K.
If an accelerated filer changes its fiscal year end, the transition report deadlines are phased in under the same schedule as quarterly and annual reports on Forms 10-Q and 10-K.

2. Definitions

*Large Accelerated Filer Definition*

A registrant becomes a large accelerated filer if it meets all of the following criteria at the end of its fiscal year:

- the registrant has been a reporting company under Section 13(a) or 15(d) of the Exchange Act for a period of at least 12 calendar months,
- the registrant has filed at least one annual report pursuant to Section 13(a) or 15(d) of the Exchange Act,
- the registrant had worldwide market value of outstanding voting and non-voting common equity held by non-affiliates of $700 million or more as of the last business day of its most recently completed second fiscal quarter, and
- the registrant is not eligible to use small business forms (10-KSB and 10-QSB) for its annual and quarterly reports.

A large accelerated filer that has an aggregate worldwide market value of the voting and non-voting common equity held by non-affiliates less than $500 million, as of the last business day of the registrant’s most recently completed second quarter, may exit large accelerated filer status at the end of that fiscal year. The registrant would file its annual report for that year and subsequent periodic reports as an accelerated filer, or a non-accelerated filer, as appropriate. Thereafter, a registrant would again have to satisfy the large accelerated filer definition to become subject to the large accelerated filing requirements.

*Accelerated Filer Definition*

A registrant becomes an accelerated filer if it meets all of the following criteria at the end of its fiscal year:

- the registrant has been a reporting company under Section 13(a) or 15(d) of the Exchange Act for a period of at least 12 calendar months,
- the registrant has filed at least one annual report pursuant to Section 13(a) or 15(d) of the Exchange Act,
- the registrant had a non-affiliated common equity public float of $75 million or more, but less than $700 million, as of the last business day of its most recently completed second fiscal quarter, and
- the registrant is not eligible to use small business forms (10-KSB and 10-QSB) for its annual and quarterly reports.

An accelerated filer that has an aggregate worldwide market value of the voting and non-voting common equity held by non-affiliates less than $50 million, as of the last business day of
the registrant’s most recently completed second quarter, may exit accelerated filer status at the end of that fiscal year. The registrant would file its annual report for that year and subsequent periodic reports as a non-accelerated filer. Thereafter, a registrant would again have to satisfy the accelerated filer definition to become subject to the accelerated filing requirements.

**Forms 10-K and 10-Q Disclosures**

The rules require that all Exchange Act registrants filing on Form 10-K include cover page disclosures in their Forms 10-K. The amended cover page requires the registrant to indicate by check mark whether it is a large accelerated filer, an accelerated filer or a non-accelerated filer and to disclose its worldwide non-affiliated common equity public float as of the end of the last business day of the registrant’s most recently completed second fiscal quarter. The filing status disclosure is also required on Form 10-Q.

If a registrant’s cover page to its Form 10-K incorrectly depicts its filing status or mistakenly discloses its non-affiliated common equity public float as of the date of filing, rather than as of the last business day of its most recently completed second fiscal quarter, it should file an amended Form 10-K. That amendment should include a corrected cover page, a new signature page, and Exhibit 31, a revised 302 certification required by Item 601 of Regulations S-K and S-B which includes the first 2 certifying statements. Note that both the share price and outstanding share amount must be as of the last business day of the most recently completed second fiscal quarter.

For purposes of completing the cover page to their first Form 10-K, we have advised registrants who complete their IPO after their most recently completed second quarter to compute their worldwide common equity public float as of a date within 60 days of filing the report. This method was used prior to the adoption of the new rules. Note that this is only to fulfill the cover page disclosure requirement. It does not mean the issuer uses that common equity public float to determine whether it is a large accelerated filer or an accelerated filer. In this scenario, the registrant would not qualify as a large accelerated filer or an accelerated filer because it was not a public company for 12 months and it had not filed at least one annual report as of its fiscal year-end.

**Transactional Filings**

In addition to accelerating the Form 10-Q filing deadlines, the rules accelerated the updating requirements of interim financial statements required in registration statements at the time of effectiveness and in proxy statements at the time they are mailed to conform to the accelerated phase-in filing deadlines of Form 10-Q. Therefore, if the registrant meets the definition of a large accelerated filer or an accelerated filer, its interim financial statements cannot be older than 129 days.

An accelerated filer that meets the three tests specified in S-X Rule 3-01(c) must update to include its audited year-end financial statements using the same phase-in schedule for its Form 10-K. Therefore, an accelerated filer meeting the tests must include its audited year-end financial statements by 75 days after year-end. For fiscal years ending on or after December 15, 2006, a large accelerated
filer must include its audited year-end financial statements by 60 days after year-end (75 days for fiscal years ending before December 15, 2006).

If the filer does not meet the Rule 3-01(c) tests, it will still be able to delay updating to include its year-end financial statements until 45 days after its year-end. The 45-day period has not changed. Note that, despite the stipulated timeframes, registrants are required to include their year-end audited financial statements in definitive proxy statements and registration statements at the time of effectiveness if they are available.

**Financial Statements under S-X Rules 3-05 and 3-09**

The requirement for updating interim and fiscal year-end financial statements of an acquired business included in an acquirer’s Form 8-K or in its proxy/registration statement under S-X Rule 3-05 has been accelerated only when the acquired company is itself a large accelerated filer or an accelerated filer. Therefore, an acquirer must include the financial statements of the acquired business at least as current as the financial statements required to be filed by the acquired company in its own periodic reports. Large accelerated filers and accelerated filers still have 75 days from consummation to file 3-05 financial statements on Form 8-K.

Separate financial statements of unconsolidated subsidiaries and 50% or less owned persons required by S-X Rule 3-09 will not be accelerated for inclusion in the parent’s Form 10-K unless both the parent and the subsidiary/investee are accelerated filers.


**Background**

Section 404 of the Sarbanes-Oxley Act directed the Commission to adopt rules requiring each annual report of a registrant, other than a registered investment company, to contain (1) a statement of management’s responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) management’s assessment, as of the end of the registrant’s most recent fiscal year, of the effectiveness of the registrant’s internal control structure and procedures for financial reporting. Section 404 also requires the registrant’s auditor to attest to, and report on management’s assessment of the effectiveness of the registrant’s internal controls and procedures for financial reporting in accordance with standards established by the Public Company Accounting Oversight Board. The Commission adopted final rules on May 27, 2003, in Release No. 34-47986 concerning management’s report on internal control over financial reporting and certification of disclosures in Exchange Act periodic reports.

The final rules require that management’s annual internal control report include:

- a statement of management’s responsibility for establishing and maintaining adequate internal control over financial reporting for the registrant,
management’s assessment of the effectiveness of the registrant’s internal control over financial reporting as of the end of the registrant’s most recent fiscal year,

• a statement identifying the framework used by management to evaluate the effectiveness of the registrant’s internal control over financial reporting, and

• a statement that the registered public accounting firm that audited the registrant’s financial statements included in the annual report has issued an attestation report on management’s assessment of the registrant’s internal control over financial reporting.

Under the new rules, a registrant is required to file the registered public accounting firm’s attestation report as part of the annual report. The rules also require that management evaluate any change in the registrant’s internal control over financial reporting that occurred during a fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant’s internal control over financial reporting.

The Commission also adopted amendments to rules and forms under the Securities Exchange Act of 1934 and the Investment Company Act of 1940 to revise the Section 302 certification requirements and to require registrants to provide the certifications required by Sections 302 and 906 of the Sarbanes-Oxley Act of 2002 as exhibits to certain periodic reports. The amendments permit registrants to furnish rather than file the Section 906 certifications with the Commission. Thus, the certifications will not be subject to liability under Section 18 of the Exchange Act. Moreover, the certifications will not be subject to automatic incorporation by reference into a registrant’s Securities Act registration statements, which are subject to liability under Section 11 of the Securities Act, unless the registrant takes steps to include the certifications in a registration statement.

Compliance Dates

On August 9, 2006, the Commission amended the compliance date for foreign private issuers that are accelerated filers (but not large accelerated filers), and that file their annual reports on Form 20-F or 40-F, to begin complying with the Section 404(b) requirement to provide an auditor's attestation report on internal control over financial reporting to fiscal years ending on or after July 15, 2007 (see Release No. 33-8730A). This group of registrants will be required to comply only with the Section 404 requirement to include management's report in the Form 20-F or 40-F annual report filed for their first fiscal year ending on or after July 15, 2006. They will not need to comply with the requirement to provide the registered public accounting firm's attestation report until they file a Form 20-F or 40-F annual report for a fiscal year ending on or after July 15, 2007. This extension was a final Commission action and was effective on September 14, 2006.

The current compliance schedule for the rules regarding the management and auditor reports on internal controls is as follows:

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<td>Management’s Assessment (Section 404(a))</td>
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On August 9, 2006, the Commission issued a proposal to extend the date by which non-accelerated filers must start providing a report by management assessing the effectiveness of the company's internal control over financial reporting (see Release No. 33-8731). The initial compliance date for these registrants would be moved from fiscal years ending on or after July 15, 2007 to fiscal years ending on or after Dec. 15, 2007. The Commission also proposed to extend the date by which non-accelerated filers must begin to comply with the Section 404(b) requirement to provide an auditor's attestation report on internal control over financial reporting in their annual reports. This deadline would be moved to the first annual report for a fiscal year ending on or after Dec. 15, 2008. This proposed extension would result in all non-accelerated filers being required to complete only the management's portion of the internal control requirements in their first year of compliance with the requirements.

On August 9, 2006, the Commission issued a proposal to extend the date by which non-accelerated filers must start providing a report by management assessing the effectiveness of the company's internal control over financial reporting (see Release No. 33-8731). The initial compliance date for these registrants would be moved from fiscal years ending on or after July 15, 2007 to fiscal years ending on or after Dec. 15, 2007. The Commission also proposed to extend the date by which non-accelerated filers must begin to comply with the Section 404(b) requirement to provide an auditor's attestation report on internal control over financial reporting in their annual reports. This deadline would be moved to the first annual report for a fiscal year ending on or after Dec. 15, 2008. This proposed extension would result in all non-accelerated filers being required to complete only the management's portion of the internal control requirements in their first year of compliance with the requirements.

Also in Release No. 33-8731, the Commission proposed a transition period for newly public companies. This transition relief would apply to any company that has become public through an IPO or a registered exchange offer, or that otherwise becomes subject to the Exchange Act reporting requirements. It would include a foreign private issuer that is listing on a U.S. exchange for the first time. The amendment would provide that a company would not be required to provide either a management assessment or an auditor attestation report until it has previously filed one annual report with the Commission.

Comments on the proposed amendments in Release No. 33-8731 were due by September 14, 2006.

**Actions to Improve Implementation of Internal Control Reporting Provisions**

The Commission held public roundtables on April 13, 2005 and May 10, 2006 on Implementation of Internal Control Reporting Provisions, and received extensive feedback. Messages from the roundtables centered around the benefits of Section 404 and the cost of implementation While a portion of the costs likely reflect start-up expenses from this new requirement, it also appears that some non-trivial costs may have been unnecessary, due to excessive, duplicative or misfocused efforts. The Commission received specific feedback about issues that remain to be addressed, and actions that the Commission and the PCAOB could take to make internal control assessment and auditing more efficient and effective. In addition, the Advisory Committee on Smaller Public Companies reported, following a year-long study, that

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<td>Domestic Large Accelerated and Accelerated Filers</td>
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<td>Foreign Large Accelerated and Accelerated Filers</td>
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<td>All Non-Accelerated Filers (see discussion in next paragraph)</td>
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<td>Auditor Attestation (Section 404(b)):</td>
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companies which have not yet undertaken the process have special concerns with both costs and procedures.

As a result of the concerns expressed at the first roundtable, on May 16, 2005 the Commission staff released a Staff Statement on Management's Report on Internal Control Over Financial Reporting to provide additional guidance and clarification of certain issues (see the Staff Statement at http://www.sec.gov/info/accountants/stafficreporting.htm). An overarching principle of this guidance is the responsibility of management to determine the form and level of controls appropriate for each company and to scope their assessment and the testing accordingly. Registered public accounting firms should recognize that there is a zone of reasonable conduct by companies that should be recognized as acceptable in the implementation of Section 404. The SEC staff guidance complements the guidance that the PCAOB provided on the same date with respect to the application of its Auditing Standard No. 2, An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of the Financial Statements.

As a result of the feedback from the second roundtable and other sources, the Commission announced on May 17, 2006 a series of actions to improve the implementation of the Section 404 internal control requirements of the Sarbanes-Oxley Act of 2002. The actions the Commission expects to take include (see Press Release No. 2006-75 for more detail):

- Guidance for management on how to complete its assessment of internal control over financial reporting, as required by Section 404(a) of the Sarbanes-Oxley Act. To prepare for the issuance of management guidance, the Commission intends to take the following steps:
  - Concept release and opportunity for public comment, and
  - Consideration of additional guidance from COSO that addresses the needs of smaller companies.
- Revisions to Auditing Standard No. 2. The PCAOB also announced on May 17, 2006 that it intends to propose revisions to its Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements. Any final revision of AS No. 2 would be subject to SEC approval.
- SEC oversight of PCAOB inspection program. The PCAOB announced on May 1, 2006, that it would focus its 2006 inspections on whether auditors have achieved cost-saving efficiencies in the audits they have performed under AS No. 2, and on whether auditors have followed the guidance that the PCAOB issued in May and November 2005 urging them to do so. As part of the Commission's oversight of the PCAOB, the Commission staff inspects aspects of the PCAOB's operations, including its inspection program. Among other things, upon completion of the PCAOB's 2006 inspections, the staff will examine whether the PCAOB inspections of audit firms have been effective in encouraging implementation of the principles outlined in the PCAOB's May 1, 2006, statement.
- Extension of compliance for non-accelerated filers discussed above.
The staff will continue to monitor the implementation of the internal control reporting requirements. In addition, because of the importance we place on effective and efficient implementation of Section 404, all participants in the process should consider the following broad concepts:

- Both management and external auditors must bring reasoned judgment and a top-down, risk-based approach to the 404 compliance process. A one-size fits all, bottom-up, check-the-box approach that treats all controls equally is less likely to improve internal controls and financial reporting than reasoned, good faith exercise of professional judgment focused on reasonable, as opposed to absolute, assurance.

- The internal control audit should be better integrated with the audit of a company's financial statements. If management and auditors can achieve the goal of integrating the two audits, the Commission expects that both internal and external costs of Section 404 compliance will fall for most companies.

- Internal controls over financial reporting should reflect the nature and size of the company to which they relate. Particular attention should be paid to making sure that implementation of Section 404 is appropriately tailored to the operations of smaller companies. Again, this is an area where reasoned judgment and a risk-based approach must be brought to bear.

- The Commission encourages frequent and frank dialogue among management, auditors and audit committees with the goal of improving internal controls and the financial reports upon which investors rely. Management of all companies - large and small - should not fear that a discussion of internal controls with, or a request for assistance or clarification from, the auditor will, itself, be deemed a deficiency in internal control. Moreover, as long as management determines the accounting to be used and does not rely on the auditor to design or implement the controls, the Commission does not believe that the auditor's providing advice or assistance, in itself, constitutes a violation of our independence rules. Both common sense and sound policy dictate that communications must be ongoing and open in order to create the best environment for producing high quality financial reporting and auditing; communications must not be so restricted or formalized that their value is lost.

**Guidance Concerning Management’s Report on Internal Control Over Financial Reporting**

Commentary submitted to the Commission has suggested that management assessments under Section 404 have not fully reflected the top-down, risk-based approach the Commission intended. Building from the information gathered in response to the Concept Release, and from the anticipated COSO guidance, the Commission currently anticipates that it will issue guidance to management to assist in its performance of a top-down, risk-based assessment of internal control over financial reporting. To ensure that this guidance is of help to non-accelerated filers and smaller public companies, the Commission intends that this future guidance will be scalable and responsive to their individual circumstances. The guidance will also be sensitive to the fact that many companies have already invested substantial resources to establish and document
programs and procedures to perform their assessments over the last few years. The form of the guidance has yet to be determined.

On July 11, 2006 the Commission published a Concept Release as a prelude to its forthcoming guidance for management in assessing a company’s internal controls for financial reporting (see Release No. 34-54122). The Commission anticipates that the forthcoming guidance for management will cover at least the following areas:

- Identifying risks to financial statement account and disclosure accuracy and the related internal controls that address the risks, including how management might use company-level controls to address the risks
- Objectives of the evaluation procedures and methods or approaches available to management to gather evidence to support its assessment
- Factors management should consider to determine the nature, timing, and extent of its evaluation procedures
- Documentation requirements, including overall objectives of the documentation and factors that might influence documentation requirements

The Concept Release seeks feedback on each of these topics and on whether guidance should be provided in other areas as well. Comments on the Concept Release were due by September 18, 2006.


*New COSO Guidance on Section 404 Compliance*

In adopting its rules with respect to Section 404, the Commission specified that management must base its evaluation of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment. In its rule-making release on June 5, 2003, the Commission acknowledged that the original COSO (Committee of Sponsoring Organizations of the Treadway Commission) framework satisfies that criteria. The COSO internal control framework has been widely used by management and auditors in fulfilling the requirements of Section 404. However, concerns have been expressed that existing internal control frameworks are not appropriately tailored to a small business control environment and that, as a result, the costs and
burdens of internal control assessments may fall disproportionately on smaller businesses. Due to these concerns, SEC staff encouraged COSO to develop guidance on the use of their framework to address the needs of smaller businesses. On July 11, 2006, COSO published new guidance on the use of its framework to address the needs of smaller businesses in fulfilling the requirements of Section 404. COSO's guidance is entitled Internal Control Over Financial Reporting - Guidance for Smaller Public Companies; the Executive Summary is available at www.coso.org and the complete guidance can also be obtained thru the COSO website.

H. Final Rule Regarding Tender Offer Best-Price Rule (New)

On October 18, 2006, the Commission voted to adopt changes to the “best price” rule concerning tender offers (see Release No. 34-54684). The tender offer “best price” rule requires that all security holders are paid the same price per instrument in a tender offer. The changes, which were made necessary by conflicting court interpretations, make clear that compensation paid to a security holder for services doesn’t count as part of the price paid for his or her securities.

The tender offer best-price rule amendments clarify that the consideration paid to any security holder for securities tendered in a tender offer is the highest consideration paid to any other security holder for securities tendered in the offer. To ensure that investors are protected and the fundamental purpose of the rule is upheld, it also exempts compensatory arrangements from the rule so long as specific substantive standards are satisfied, and includes a safe harbor that hinges upon approval of independent members of the board of directors.

I. Rule Proposal Related to Foreign Private Issuer Deregistration (New)

On December 14, 2005, the Commission voted to propose rules concerning the process whereby a foreign private issuer can terminate reporting requirements for classes of its securities registered under the Securities Exchange Act of 1934 (see Release No. 34-53020). Under current rules, a foreign private issuer may exit the Exchange Act registration and reporting regime if the class of the issuer's securities has less than 300 record holders who are U.S. residents. Under these rules, a foreign private issuer may find it difficult to terminate its Exchange Act registration and reporting obligations despite the fact that there is relatively little investor interest in the United States.

In light of the increased internationalization of the U.S. securities markets that has occurred since the adoption of these rules, proposed Exchange Act Rule 12h-6 would allow a foreign private issuer to:

- terminate its registration of a class of equity securities under Exchange Act Section 12(g) and its resulting Section 13(a) reporting obligations or terminate, and not merely suspend, its Section 15(d) reporting obligations regarding a class
of equity securities as long as the issuer meets specified criteria designed to measure U.S. market interest for that class of securities; and

- terminate and not merely suspend, its Section 15(d) reporting obligations regarding a class of debt securities as long as it meets conditions similar to the current requirements for suspending its reporting obligations relating to that class of debt securities.

Proposed Rule 12h-6 provides guidance to assist a foreign private issuer in determining whether U.S. residents hold no more than the applicable threshold percentage of its worldwide public float or whether the number of its U.S. resident equity or debt securities record holders meet the applicable threshold condition.

Under proposed Rule 12h-6, a foreign private issuer would have to file new Form 15F with the Commission, certifying the issuer's compliance with the requirements for termination of its Exchange Act reporting obligations and providing specified supporting information. As with the filing of Form 15 under the current rules, the filing of Form 15F would automatically suspend an issuer's reporting duties. If the Commission has not objected, the suspension would become a permanent termination 90 days after the filing of the Form 15F.

J. Final Rule regarding IFRS First-time Adopters

On April 13, 2005, the Commission voted to adopt amendments that affect foreign private issuers that change their basis of accounting to international accounting standards, known as International Financial Reporting Standards (IFRS). These amendments provide an accommodation to issuers that change their basis of accounting to IFRS prior to or for the 2007 financial year. The amendments also require certain disclosures from all foreign private issuers that adopt IFRS for the first time during any financial year. The Commission is not changing current requirements regarding the reconciliation of financial statement items to generally accepted accounting principles as used in the United States (U.S. GAAP).

Issuers that are registered with the SEC generally are required to provide in their SEC filings three years of audited financial statements prepared on a consistent basis of accounting. The amendments permit eligible issuers to file two years rather than three years of statements of income, changes in shareholders' equity and cash flows prepared in accordance with IFRS in annual reports and registration statements filed during the first year in which they adopt IFRS, with appropriate related disclosure. To be eligible to rely on this accommodation, a foreign private issuer must adopt IFRS for the first time prior to or for its first financial year starting on or after January 1, 2007.

The amendments also require certain disclosures from issuers that adopt IFRS for the first time in any financial year. These requirements relate to an issuer's reliance on any of the transitional measurement exceptions available to a first-time adopter under IFRS and to the reconciliation to IFRS from the issuer's previous basis of accounting.
The Commission adopted these amendments to promote and encourage the use of IFRS as a high quality set of accounting standards. Because the Commission recognized the significant efforts associated with the adoption of IFRS, the accommodation is also intended to ease the burdens that foreign companies may face when they adopt IFRS for the first time, while improving the quality of financial disclosure that they provide to investors. Issuers that apply accounting standards as adopted by the European Union in a manner that does not fully comply with IFRS are eligible to use the accommodation if they provide U.S. GAAP and IFRS reconciling information.

**K. Rule Proposals Related to Proxy Materials**

1. **Proposals Regarding Internet Availability of Proxy Materials**

   On November 29, 2005, the Commission voted to propose rule changes that would allow companies and other persons to use the Internet to satisfy proxy requirements (See Release No. 34-52926). The proposed rules would amend the proxy rules under the Securities Exchange Act of 1934 to provide an alternative method for issuers and other persons to furnish proxy materials to shareholders by posting them on an Internet Web site and providing shareholders with notice of the availability of the proxy materials. The proposed rules are intended to put into place processes that would provide shareholders with notice of, and access to, proxy materials while taking advantage of technological developments and the growth of the Internet and electronic communications. The proposed amendments also would apply to a soliciting person other than the issuer, which may reduce the costs of engaging in a proxy contest.

**L. Electronic Access to Comment and Response Letters and Notifications of Effectiveness**

1. **Public Release of Comment Letters and Responses**

   The staff of the Securities and Exchange Commission announced on May 9, 2005 that on May 12, 2005, it would begin the process of publicly releasing comment letters and response letters relating to disclosure filings made after August 1, 2004, and reviewed by the Division of Corporation Finance and the Division of Investment Management. The staff had announced on June 24, 2004 that it would begin releasing comment letters and filer response letters relating to disclosure filings made after August 1, 2004 that were selected for review (see Press Release No. 2004-89 for additional details). The staff is releasing comment letters and response letters relating to reviewed disclosure filings on a filing-by-filing basis through our EDGAR system at [www.sec.gov](http://www.sec.gov). The process commenced with some of the oldest eligible filings; as it continues, letters will be released no earlier than 45 days after the review of the disclosure filing is complete.
2. Electronic Notifications of Effectiveness (New)

On April 25, 2006 the Commission announced an effort to provide broader and more timely public notice of important Commission actions. On May 22, 2006, the staffs of the Divisions of Corporation Finance and Investment Management began to use the EDGAR system to issue notifications of effectiveness for Securities Act registration statements and post-effective amendments, other than those that become effective automatically by law. These notifications will be posted to the EDGAR system the morning after a filing is determined to be effective. The Divisions will no longer prepare and mail paper effectiveness orders associated with these filings. Registrants will continue to be notified promptly by telephone that their registration statements or post-effective amendments are effective.

After May 22, 2006, the Commission's website began presenting a list of filings declared effective on the previous business day (see the link to the notifications of effectiveness on the Commission’s Web site at [http://www.sec.gov/cgi-bin/browse-edgar?action=geteffect](http://www.sec.gov/cgi-bin/browse-edgar?action=geteffect)). The effectiveness notices will be distributed as an EDGAR form type called "EFFECT." Consequently, for the first time, an interested person can search for a company's filings and be able to see when the staff declared a particular Securities Act registration statement effective.

M. Recent Enforcement Actions Involving GAAP

1. Enforcement Actions involving McAfee, Inc. (New)

On January 4, 2006 the Commission filed securities fraud charges against McAfee, Inc. (formerly known as Network Associates, Inc.) in a complaint that alleged that McAfee misled investors when it engaged in a fraudulent scheme to overstate its revenue and earnings by hundreds of millions of dollars from the second quarter of 1998 through 2000. The complaint specifically alleged that, during the period 1998 through 2000, McAfee inflated its cumulative net revenues by $622 million and that, for 1998 alone, McAfee overstated revenues by $562 million (a misstatement of 131%).

McAfee consented, without admitting or denying the allegations of the complaint, to a Court order enjoining it from violating the antifraud, books and records, internal controls, and periodic reporting provisions of the federal securities laws. The order also requires that McAfee pay a $50 million civil penalty, which the Commission will seek to distribute to harmed investors pursuant to the Fair Funds provision of the Sarbanes-Oxley Act of 2002. In addition, McAfee agreed to appoint an Independent Consultant to examine and recommend improvements to McAfee’s internal accounting controls and revenue recognition and reserves practices to better ensure compliance with the federal securities laws.

According to the complaint, McAfee defrauded investors into believing that it had legitimately met or exceeded its revenue projections and Wall Street earnings estimates during the 1998 through 2000 period. In reality, however, McAfee engaged in “channel stuffing” or the
aggressive overselling of its products to distributors in amounts that far exceeded the demand for the products. While engaging in this “channel stuffing,” McAfee improperly recorded the sales to distributors as revenue. McAfee offered its distributors lucrative sales incentives that included deep price discounts and rebates in an effort to persuade the distributors to continue to buy and stockpile McAfee products. McAfee also secretly paid distributors millions of dollars to hold the excess inventory, rather than return it for a refund and resulting reduction in McAfee’s revenues. In other instances, McAfee used an undisclosed, wholly-owned subsidiary, Net Tools, Inc., to repurchase inventory that McAfee had oversold to its distributors. All of these actions were inconsistent with generally accepted accounting principles (GAAP) and led to McAfee’s October 2003 restatement of its financial results for 1997 through 2003.

The complaint further alleged that McAfee took action to conceal the fraud from investors by, among other things, recording the payments and discounts that it offered to distributors in an inappropriate manner, and improperly manipulating reserve accounts to increase inadequate sales reserves and cover the costs of the distributor payments. The complaint alleged that McAfee defrauded investors by reporting false and materially misleading financial and other information in periodic reports, financial statements, and securities registration statements that McAfee filed with the Commission, in press releases, and in other public statements. See AAER No. 2360 for more information.

2. Enforcement Actions involving American International Group, Inc. (AIG) (New)

On February 9, 2006, the Commission filed and settled charges that American International Group, Inc. (AIG) committed securities fraud. The settlement was part of a global resolution of federal and state actions under which AIG will pay in excess of $1.6 billion to resolve claims related to improper accounting, bid rigging and practices involving workers’ compensation funds. AIG will pay $800 million to the Commission for the benefit of injured investors, consisting of disgorgement of $700 million and a penalty of $100 million, and undertake corporate reforms designed to prevent similar misconduct from occurring. The penalty amount takes into account AIG’s complete cooperation with the Commission staff during the investigation and its remediation efforts in response to material weaknesses identified by its internal review.

The Commission’s complaint alleged that AIG’s reinsurance transactions with General Re Corporation (Gen Re) were designed to inflate falsely AIG’s loss reserves in order to end analyst criticism that AIG’s reserves had been declining. The complaint also identifies a number of other transactions in which AIG materially misstated its financial results through sham transactions and entities created to mislead the investing public. Specifically, the Commission’s complaint alleges that in December 2000 and March 2001, AIG entered into two sham reinsurance transactions with Gen Re that had no economic substance but were designed to allow AIG to improperly add $500 million in phony loss reserves to its balance sheet in the fourth quarter of 2000 and the first quarter of 2001. In addition, the complaint alleges that in 2000, AIG engaged in a transaction with Capco Reinsurance Company, Ltd. (Capco) to conceal approximately $200 million in underwriting losses in its general insurance business by improperly converting them to capital (or investment) losses to make those losses less
embarrassing to AIG. The complaint further alleges that in 1991, AIG established Union Excess Reinsurance Company Ltd. (Union Excess), an offshore reinsurer, to which it ultimately ceded approximately 50 reinsurance contracts for its own benefit. Although AIG controlled Union Excess, it improperly failed to consolidate Union Excess’s financial results with its own, and in fact took steps to conceal its control over Union Excess from its auditors and regulators. As a result of these actions and other accounting improprieties, AIG fraudulently improved its financial results.

Shortly after federal and state regulators contacted AIG about the Gen Re transaction, AIG commenced an internal investigation that eventually led to a restatement of its prior accounting for approximately 66 transactions or items. In its restatement, AIG admitted not only that its accounting for certain transactions had been improper, but also that the purpose behind some of those transactions was to improve financial results that AIG believed to be important to the market. AIG also conceded in its restatement that certain transactions may have “involved documentation that did not accurately reflect the true nature of the arrangements … [and] misrepresentations to members of management, regulators and AIG’s independent auditors.” Furthermore, the restatement summarized several transactions that AIG accounted for improperly, including, among others, the two sham reinsurance transactions with Gen Re and certain transactions involving Capco and Union Excess. The restatement resulted in approximately $2.26 billion in charges for corrections of errors related to periods prior to fiscal 2004, reducing AIG’s shareholders’ equity at December 31, 2004 by approximately $2.26 billion (or 2.7%).

See AAER No. 2371 for more information.

3. Enforcement Actions involving Tyco International Ltd. (New)

On April 17, 2006 the Commission settled a civil injunctive action against Tyco International Ltd. Without admitting or denying the allegations in the Commission's complaint, Tyco consented to a permanent enjoinder from future violations of the federal securities laws. The proposed final judgment ordered Tyco to pay $1 in disgorgement and a $50 million civil penalty. The Commission's investigation is continuing with respect to individuals.

The Commission's complaint alleged that Tyco overstated its reported financial results by at least $1 billion from 1996 through 2002 by, among other things, employing various improper accounting practices and a scheme involving transactions with no economic substance in violation of the federal securities law.

The Commission's complaint alleged that Tyco inflated its operating income by at least $500 million as a result of improper accounting practices related to some of its many acquisitions that included undervaluing acquired assets, overvaluing acquired liabilities, and misusing accounting rules concerning the establishment and utilization of purchase accounting reserves. The complaint further alleged that Tyco also improperly established and used various kinds of reserves to make adjustments at the end of reporting periods to enhance and smooth its publicly reported results and to meet earnings forecasts.
In addition, the complaint alleged that Tyco inflated its operating income by $567 million from its fiscal year 1998 through its fiscal quarter ended December 31, 2002, by recognizing revenue for connection fees that its ADT Security Services, Inc. subsidiary charged to dealers from whom it purchased security monitoring contracts. Because the connection fee was fully offset by an equal increase in the purchase price ADT allocated to the purchased dealers' security monitoring contracts, the connection fee transactions lacked economic substance and should not have been recorded in Tyco's income statement. In 2003, Tyco restated its operating income and cash flow relating to the connection fees.

The complaint further alleged that, from September 1996 through early 2002, Tyco failed to disclose in its proxy statements and annual reports certain executive compensation, executive indebtedness, and related party transactions of its former senior management. Tyco also incorrectly accounted for certain executive bonuses paid in fiscal years 2000 and 2001, thereby failing to expense the costs of the bonuses in its financial statements. Finally, the complaint alleged that Tyco violated the antibribery provisions of the Foreign Corrupt Practices Act when employees or agents of its Brazilian subsidiary made payments to Brazilian officials to obtain or retain business for Tyco.

Between 1996 and 2002, as a result of these various practices, Tyco made false and misleading statements or omitted information in its filings with the Commission and in its public statements to investors and analysts. See AAER No. 2414 for more details.

4. Enforcement Actions involving Netopia, Inc. (New)

On March 29, 2006, the Commission charged two former sales executives of Emeryville, California-based Netopia, Inc. with fraudulently boosting the company's revenue. The Commission also filed, and simultaneously settled, charges against CEO Alan B. Lefkof and former CFO William D. Baker, alleging that the executives later learned of a side agreement yet failed to take timely corrective action. In a related proceeding, the Commission instituted and simultaneously settled administrative cease-and-desist proceedings against Netopia. Without admitting or denying the Commission's findings, Netopia agreed to cease and desist from future violations of the corporate reporting, books and records and internal controls provisions of the federal securities laws.

Baker and Lefkof consented to pay civil penalties of $35,000 each, while Baker also consented to a bar from serving as an officer or director of a public company for five years, and an a bar from practicing before the Commission as an accountant for five years under SEC Rule of Practice 102(e).

The complaint charged Baker and the former sales executives with securities fraud, and charged Lefkof with violating the antifraud provisions of the Securities Act. The complaint also charged all of the defendants with causing Netopia to report false financial information to the Commission. The complaint additionally charged all of the defendants with causing Netopia's failure to maintain accurate books and records, and charges Lefkof and Baker with causing the company's failure to maintain adequate internal controls. The complaint also charged Baker and the former sales executives with circumventing internal accounting controls and charged all of
the defendants with falsifying the company's books and records. Baker, in the complaint, was further charged with lying to accountants and falsely certifying Netopia's financial statements.

The Commission's complaint alleged that the two sales executives, Netopia’s former head of worldwide sales, Thomas A. Skoulis and the former head of software sales, Peter M. Frankel entered into two secret side deals in 2002 and 2003, each for approximately $750,000. Pursuant to the side deals, Netopia's customer, which had limited resources, would only have to pay Netopia if and when it successfully resold the software to an end-user. It was improper to record revenue for the transactions because payment was contingent on future events. Skoulis and Frankel concealed the deal terms from Netopia's finance department. In connection with the 2002 deal, Frankel directed that contingency language be physically "whited out" from the face of the customer's purchase order. For the 2003 deal, Skoulis directed Frankel to hide a copy of the customer's side letter that set forth the contingency. Their actions caused Netopia to report fraudulently inflated software revenue to the investing public, and for the fourth quarter ended September 30, 2003, allowed the company to report its first profitable quarter in three years.

The complaint also alleged that in April 2004 Baker, and later Lefkof, learned of the payment contingency associated with the 2003 transaction but failed to take immediate corrective action. Rather than take corrective action, Baker concealed the side agreement from Netopia's Audit Committee, including requesting that the customer delete references to the deal in communications with Netopia. Later, on July 2, 2004, Lefkof obtained a copy of the side agreement containing the payment contingency for the 2003 deal. Notwithstanding their knowledge of the side agreement, Lefkof and Baker allowed Netopia to issue a misleading press release on July 6, 2004, that incorrectly treated the outstanding order as merely an uncollectible bad debt. In actuality, the Commission alleged, the sale should never have been recorded as revenue, and Netopia should have restated its 2003 financial statements.

See AAER Nos. 2403 and 2404 for more information. Charges against the former sales executives are pending.

5. **Enforcement Actions involving Dollar General Corporation (Updated)**

On April 11, 2006, the Commission settled its complaint against Brian Burr ("Burr"), former CFO at Dollar General Corporation ("Dollar General"). Burr was the only litigating defendant in the Commission's action filed on April 7, 2005 against Dollar General and several of its former officers and employees for alleged accounting fraud that overstated Dollar General's earnings. In settling with the Commission, Burr consented, without admitting or denying the Commission's allegations, to be permanently enjoined from violating the antifraud and other provisions of the federal securities laws, pay a $1.2 million in civil penalties, disgorgement, and prejudgment interest, and a bar from serving as an officer or director of a public company for five years. Dollar General and four other individuals have previously settled the Commission's actions against them.

In its complaint, the Commission charged Burr with insider trading, violating the antifraud, books and records and internal controls provisions of the federal securities laws and
aiding and abetting the books and records, periodic reporting and internal controls provisions of the securities laws. In its complaint the Commission alleged that, in 1999 and 2000, Dollar General's accounting staff determined that Dollar General should have recognized $13.4 million in import freight expenses in fiscal 1999. Rather than restating prior periods, as required by GAAP, or recognizing all the expense in fiscal year 1999, Burr participated in discussions of possible ways to account for the $13.4 million in freight expenses to avoid recognizing all such expenses in fiscal year 1999. The complaint further alleged that on February 5, 2000, Dollar General's former controller sent a memorandum to Burr and others describing a $10 million "variance" in relation to freight expenses, and Dollar General's intention to charge the "$10 million 1999 shortfall" at a rate of $833,000 per month during Dollar General's fiscal year 2000. Ultimately, Dollar General recorded the shortfall in this manner. Burr knew that deferring the bulk of the expenses to fiscal year 2000 avoided the negative impact on already announced fiscal year 1999 earnings as well as year-end bonus payments to Dollar General employees, including Burr. The Commission's complaint alleges that, by deferring the freight expenses, Dollar General met certain targets, including an internal target for employee bonuses and analysts' expectations for the Company's earnings per share for fiscal year 1999. If Dollar General had recognized the freight expenses in 1999, it would have fallen short of the bonus target and analysts' expectations.

The complaint further alleged that Burr engaged in insider trading. After Dollar General terminated Burr in February 2001, Burr and his counsel met with Dollar General senior management. At this meeting, on April 12, 2001, Burr's counsel told Dollar General management that Burr could not sign a separation agreement until he knew that certain accounting issues were addressed by Dollar General. Burr also wanted a release from the Company for any responsibility for certain accounting issues. In April 2001, Burr exercised Dollar General options on two occasions and sold 131,597 Dollar General shares at sales prices ranging from $22.50- $24.02. After the Company's April 30, 2001 press release announcing accounting irregularities and the necessity for a restatement, Dollar General's stock price dropped from its Friday, April 27, 2001 closing price of $23.00 to a Tuesday, May 1, 2001 closing price of $15.76. The complaint alleged that Burr avoided losses by his sale of Dollar General securities.

See AAER Nos. 2411 and 2226 for more details.

6. Enforcement Actions involving Raytheon Company (New)

On June 28, 2006, the Commission settled enforcement proceedings against Raytheon Company ("Raytheon"), its former Chairman and CEO, Daniel P. Burnham, and the former Deputy CFO and Controller of Raytheon Aircraft Company ("RAC"), Aldo R. Servello. The SEC charged that, in periodic reports filed with the Commission from 1997 to 2001, Raytheon made false and misleading disclosures and used improper accounting practices that operated as a fraud by failing to adequately and accurately disclose the declining financial results and deteriorating business of one of Raytheon’s operating segments, its commercial aircraft manufacturing subsidiary RAC. The Commission also charged that certain of these disclosures and accounting practices were undertaken with the knowledge of Burnham in 2000 and 2001 and Servello in 2000. Without admitting or denying the SEC’s findings or allegations, Raytheon,
Burnham, and Servello agreed to settle these charges by consenting to the entry of a Cease and Desist Order by the Commission and to civil monetary penalties and disgorgement.

Raytheon’s improper accounting and disclosures involved the practices of prematurely recognizing revenue and delaying significant losses for certain aircraft in hopes of eventually turning RAC around. From 1997 through 1999, Raytheon prematurely recognized revenue on RAC’s sale of unfinished aircraft through improper “bill and hold” transactions that did not comply with GAAP. These practices resulted in material overstatements of RAC’s reported annual net sales revenue by approximately $80 million at year-end 1997 and $110 million at year-end 1998, which led to 13 percent overstatements of the subsidiary’s annual operating income in both of these periods. These errors enabled both Raytheon and RAC to meet certain internal and external earnings targets. Although Raytheon did restate for these material errors at year-end 1999, the company misleadingly attributed the restatement to additional “clarification” purportedly provided by “new guidance” on revenue recognition issued by the Commission in Staff Accounting Bulletin No. 101 (“SAB 101”), instead of the improper accounting practices that had occurred at RAC prior to that time.

In addition, between 1997 and 2001, Raytheon failed to fully and accurately disclose known risks, trends, uncertainties, and other information concerning the deteriorating state of RAC’s commuter aircraft business and the negative impact this decline was having on asset values associated with RAC’s line of nineteen-seat, turboprop aircraft (the commuters) and, thus, on Raytheon and RAC’s results of operations. Raytheon also engaged in several improper accounting practices that delayed and mischaracterized known losses associated with RAC’s commuter line during this time period.

Had Raytheon properly accounted for its commuter assets, the Commission alleged the company would have reported material reductions in RAC’s reported operating income of at least $34 million, $22 million, and $21 million at year-end 1998, 1999, and 2000, respectively, which represented 13 percent of the subsidiary’s reported annual operating income in each of these periods. Moreover, RAC’s operating results would have been further reduced by at least $67 million (41 percent) at year-end 2000 had Burnham, Servello, and other senior Raytheon and RAC management timely and appropriately recognized losses inherent in a planned “soft landing” of the commuter aircraft line. In addition, at this time, internal company documents and other information indicate that these senior executives expected commuter losses of $240 million given the cash sales prices that had been approved in the “soft landing,” and a charge of $67 million to $240 million would have reduced Raytheon’s 2000 profit before taxes by at least 8 to 27 percent. Burnham and other senior Raytheon officers, however, caused Raytheon to improperly take this charge in the third quarter of 2001, when the company wrote down its on- and off-balance sheet commuter assets by $693 million after the terrorist attacks of September 11th. Given the charge that should have been taken at year-end 2000, Raytheon’s third quarter 2001 commuter loss provision was overstated by 10 to 53 percent.

Each respondent agreed to cease and desist from committing or causing the violations charged as well as any future violations of these provisions. Raytheon, Burnham, and Servello also consented to the entry of a final judgment in a related civil action filed in the U.S. District Court for the District of Columbia for the purposes of awarding civil monetary penalties and
The Commission’s investigation as to other individuals involved in this matter is continuing. See AAER 2449 for more details.

N. Recent Enforcement Actions Involving MD&A

1. Enforcement Action involving The Coca-Cola Company

On April 18, 2005, the Commission announced a settled cease-and-desist proceeding against The Coca-Cola Company relating to its failure to disclose certain quarter-end sales practices used to meet earnings expectations. Coca-Cola also has voluntarily undertaken steps to strengthen its internal disclosure review process to prevent future violations.

The Commission found that, at or near the end of each reporting period between 1997-1999, Coca-Cola employed an undisclosed "channel stuffing" practice in Japan known as "gallon pushing" to record sales in a current period that would have occurred in future periods. Specifically, Coca-Cola offered Japanese bottlers extended credit terms to induce them to purchase quantities of beverage concentrate they otherwise would not have purchased until a later period.

As a result of gallon pushing, from 1997 to 1999 Coca-Cola's Japanese bottlers' concentrate inventory levels increased at more than a five times greater rate than that of finished product sales to retailers. Gallon pushing resulted in Coca-Cola prematurely recording sales that would have occurred in later periods and made it likely that Coca-Cola's bottlers would purchase less concentrate in later periods. This practice contributed approximately $0.01 to $0.02 to Coca-Cola's quarterly EPS and resulted in Coca-Cola meeting as opposed to missing analysts' consensus or modified consensus earnings estimates in 8 out of the 12 quarters from 1997-1999. Despite the impact to current earnings and the likely impact to future earnings, Coca-Cola failed to disclose its gallon pushing practice in its periodic reports. Coca-Cola misled investors by failing to disclose in MD&A the period-end practices that impacted the company's current and future operating results.

Also, Coca-Cola made misstatements in a January 2000 Form 8-K about a subsequent inventory reduction, which continued to conceal the impact of prior end-of-period practices and further misled investors. In that Form 8-K, Coca-Cola disclosed that a worldwide concentrate inventory reduction was planned to occur during the first half of the year 2000. The Form 8-K described the inventory reduction as a joint action between Coca-Cola and its bottlers and that certain bottlers throughout the world, specifically including those in Japan, had indicated that they intended to reduce their inventory levels during the first half of the year 2000, when in fact the bottlers were unaware of the inventory reduction.
As set forth in the Form 8-K, the impact on Coca-Cola's earnings for the first and second quarter of 2000 was estimated to be between $0.11 and $0.13 per share. The Form 8-K, however, did not disclose that more than $0.05 of the estimated earnings impact would be attributable to an anticipated reduction of sales for Japan with a corresponding gross profit impact more than five times greater than that of any other operating division in the world.

Although the Commission did not make findings about Coca-Cola's accounting treatment for its gallon pushing sales, it did find that Coca-Cola's failure to disclose the impact of gallon pushing on current and future earnings, as well as the false statements and omissions within the Form 8-K, violated certain antifraud and periodic reporting requirements of the federal securities laws. See AAER-2232 for more details.

2. Enforcement Actions involving Kmart

On August 23, 2005, the Commission filed charges against two former top Kmart executives for misleading investors about Kmart's financial condition in the months preceding its bankruptcy. The Commission's complaint alleges that the former CEO Charles Conaway and former CFO John McDonald are responsible for materially false and misleading disclosures about the company's liquidity and related matters in the MD&A section of Kmart's Form 10-Q for the third quarter and nine months ended October 31, 2001, and in an earnings conference call with analysts and investors.

The Commission alleges that Conaway and McDonald failed to disclose in MD&A the reasons for a massive inventory overbuy in the summer of 2001 and its impact on the company's liquidity. The MD&A disclosure attributed increases in inventory to "seasonal inventory fluctuations and actions taken to improve our overall in-stock position" where, in reality, a significant portion of the inventory buildup was allegedly caused by the purchase of $850 million of excess inventory. The defendants allegedly dealt with Kmart's liquidity problems by delaying payments owed vendors, thereby effectively borrowing $570 million from them by the end of the third quarter. Kmart filed for bankruptcy on January 22, 2002.

The Commission's complaint seeks as relief permanent injunctions, disgorgement with prejudgment interest, civil penalties and officer and director bars. See AAER-2295 for more details. The Commission’s Kmart investigation is continuing.
II. Other Current Accounting and Disclosure Issues

A. Adoption of a New Accounting Standard in an Interim Period (New)

Article 10 of Regulation S-X specifies the form and content of interim financial statements. While there is no need to duplicate disclosure contained in the latest audited financial statements, Item 10-01(a)(5) of Regulation S-X includes information on certain disclosure that should be included in the footnotes that accompany the interim financial statements. The requirements specifically include disclosure of events subsequent to the end of the most recent fiscal year that have a material impact on the registrant and one of the examples given is a change in accounting principle.

Registrants that adopt a new accounting standard in an interim period should describe the accounting change and its impact pursuant to Accounting Principles Board Opinion No. 28, *Interim Financial Reporting*, as amended by FASB Statement No. 154, *Accounting Changes and Error Corrections*. In addition, the interim financial statements should include, to the extent applicable, all disclosures identified by the adopted standard as required to be included in annual financial statements. These disclosures should continue to be provided in subsequent interim financial statements until the accounting change is reflected in audited annual financial statements. If the change in accounting principle is made in a period other than the first quarter of the year, no amendment of prior filings is required, however, a restatement of each of the prior quarter’s results should be included in the filing for the quarter in which the new accounting principle is adopted pursuant to APB 28. If the new accounting principle is applied retrospectively to prior years, the prior comparable interim quarters should also be presented on a restated basis.

There may be circumstances related to particular accounting changes where the disclosure required may be either burdensome to prepare on an interim basis or may not be particularly meaningful to investors on an interim basis. For example, most of the disclosure required by FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, is required to be disclosed at the end of each annual reporting period and could be unduly burdensome to prepare on an interim basis. Therefore, registrants should disclose the change in accounting principle as a result of adopting FIN 48 and the total amount of unrecognized tax benefits recorded, however, the tabular and other disclosures required by paragraph 21 of FIN 48 are not required in the interim period financial statements. Any material changes to the unrecognized tax benefits that occur during subsequent interim periods should be disclosed pursuant to Item 10-01(a)(5) of Regulation S-X and discussed in MD&A. If the registrant’s accounting change includes changing its policy on classification of interest and penalties, it should provide the disclosure required by SFAS 154 (note that no preferability letter is required for the classification change related to the adoption of FIN 48, but would be required if a change in classification is made after adopting FIN 48).
B. **Classification and Measurement of Warrants and Embedded Conversion Features (Updated)**

EITF 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock*, contains explicit guidance regarding the classification and measurement of warrants and instruments with embedded conversion features. The overall concept of EITF 00-19 is that balance sheet classification is based upon the settlement terms specified by the contract. If the contract requires settlement in shares and the related criteria in EITF 00-19 are met, equity classification of the contract is appropriate. If the contract requires net-cash settlement, the contract would be classified as a liability. However, before considering the requirements of EITF 00-19, registrants that issue warrants, convertible preferred stock or convertible debt should first determine whether these instruments fall within the scope of FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. If they are excluded from the scope of SFAS 150, registrants must then determine whether the instrument is within the scope of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Instruments within the scope of SFAS 150 or SFAS 133 will not qualify for treatment as equity.

1. **Freestanding Instruments - Warrants**

Since warrants are freestanding instruments, the warrants should be analyzed to determine whether they meet the definition of a derivative under SFAS 133 (paragraphs 6-9), and if so, whether they meet the scope exception in paragraph 11 of SFAS 133. If the warrant does not meet the definition of a derivative under SFAS 133, it must be evaluated under EITF 00-19 to determine whether the instrument should be accounted for as a liability or as equity. In order to determine that equity classification of the contract is appropriate, all of the criteria for equity classification in paragraphs 7-32 of EITF 00-19 must be met. These criteria relate to contract terms, not the likelihood of any particular term being triggered. Failure to meet any of these criteria results in classification of the contract as a liability.

While all of the criteria in paragraphs 7-32 should be analyzed, the most common reasons for a conclusion to account for warrants as liabilities are:

1. the warrants could be required to be settled in cash if certain events occurred, such as delisting from the registrant’s primary stock exchange or in the event of a change of control; and
2. the registrant elected an accounting policy for the registration rights agreement that considered the registration rights agreement and the warrant together as a unit and the registration rights agreement could require significant liquidated damages be paid to the holder of the instrument in the event the issuer fails to register the underlying shares under a preset timeframe, or in some cases, where the issuer fails to maintain an effective registration statement with a current prospectus for a preset time period. The liquidated damages usually are expressed as a percentage of the original amount invested by the holder and may or may not be capped at a certain maximum percentage.
In June 2005, the EITF began deliberating the effect of a liquidated damages clause on a freestanding financial instruments, such as warrants. The preliminary deliberations resulted in 4 alternative views (see the deliberations of EITF Issue 05-4). In September 2005, the FASB staff postponed further deliberations by the EITF until the FASB could address whether a separate registration rights agreement is a derivative under FASB SFAS 133. On October 20, 2006, the FASB issued a proposed FSP, No. EITF 00-19-b Accounting for Registration Payment Arrangements (see http://www.fasb.org/fasb_staff_positions/prop_fsp_eitf00-19-b.pdf). The proposed FSP specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement, whether issued as a separate agreement or included as a provision of a financial instrument or other agreement, should be separately recognized and measured in accordance with FASB Statement No. 5, Accounting for Contingencies. The comment period on the proposed FSP ends December 4, 2006. Until the final FSP is issued and adopted, registrants should continue to use their existing accounting policy consistently among all of their contracts, along with clear disclosure regarding the policy selected. Upon the issuance of the anticipated FSP, which for calendar year companies is expected to go into effect beginning with the first quarter of 2007, registrants should apply the transition guidance in the FSP.

As previously mentioned, in analyzing instruments under EITF 00-19, the probability of the event occurring is not a factor. For example, certain warrants can only be settled in cash if the registrant’s stock is delisted from its primary stock exchange. Even if delisting is not considered probable of ever occurring, the warrants would still be classified as a liability under the EITF 00-19 analysis. Similarly, the likelihood that a change in control could occur is not a factor.

2. **Embedded Conversion Features – Convertible Debt and Convertible Preferred Stock**

The embedded conversion feature within convertible debt and convertible preferred stock must be assessed under paragraph 12 of SFAS 133 to determine whether the embedded conversion feature should be bifurcated from the host instrument and accounted for as a derivative at fair value with changes in fair value recorded in earnings. If the embedded conversion feature is not required to be bifurcated under SFAS 133, the convertible instrument should be accounted for in accordance with Accounting Principles Board Opinion No. 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants (APB 14). Registrants also should consider Accounting Series Release No. 268, Redeemable Preferred Stocks (ASR 268), and EITF D-98, Classification and Measurement of Redeemable Securities, for the classification and measurement of the instrument, and EITF 98-5, Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios, and EITF 00-27, Application of Issue No. 98-5 to Certain Convertible Instruments, for consideration of any beneficial conversion feature.

Embedded conversion features that meet the criteria for bifurcation under SFAS 133 may qualify for the paragraph 11(a) scope exception in SFAS 133. In analyzing whether the conversion feature meets the paragraph 11(a) scope exception, one of the things the registrant must determine is whether the conversion feature would be classified within stockholders’
To determine classification, the conversion feature must be analyzed under EITF 00-19. The first step of the EITF 00-19 analysis for these features is to determine whether the host contract is a conventional convertible instrument (paragraph 4 of EITF 00-19 and EITF 05-2, The Meaning of "Conventional Convertible Debt Instrument" in EITF Issue 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock"). One of the common features that prevents the convertible instrument from qualifying as "conventional" is a reset provision in the instrument where, if a company issues an instrument in the future that has a price less than the conversion price in the convertible instrument, the conversion price in the convertible instrument is reset. If the instrument is a conventional convertible instrument, the embedded conversion option would qualify for equity classification under EITF 00-19, qualify for the scope exception in SFAS 133 and not be bifurcated from the host instrument. In that case, the convertible instrument should be accounted for in accordance with APB 14; ASR 268 and EITF Topic D-98 should be considered for the classification and measurement of the instrument; and EITFs 98-5 and 00-27 should be considered for any beneficial conversion feature.

If the instrument does not qualify as conventional convertible, paragraphs 7-32 of EITF 00-19 must be analyzed to determine whether the conversion feature should be accounted for as a liability or equity. If the feature is classified as a liability under EITF 00-19, it would not qualify for the paragraph 11 scope exception in SFAS 133 and therefore the feature would be accounted for as a derivative at fair value, with changes in fair value recorded in earnings. If the feature is classified as equity under EITF 00-19 and meets the other criterion in the SFAS 133 paragraph 11 scope exception, the embedded conversion option is not bifurcated from the host instrument. The registrant should assess whether the convertible preferred stock instrument should be classified in permanent equity or temporary equity by reference to ASR 268 and EITF D-98. Additionally, registrants should assess whether there is a beneficial conversion feature that must be accounted for under EITFs 98-5 and 00-27.

Registrants should ensure that they have properly considered SFAS 133 and EITF 00-19 in accounting for the conversion feature embedded within their convertible debt and convertible preferred stock instruments. The two most common causes of improper accounting stem from the following terms:

1. the number of shares issuable upon conversion of the convertible instrument is variable, and there is no cap on the number of shares which could be issued; and
2. the registrant elected an accounting policy for the registration rights agreement that considered the registration rights agreement and the convertible instrument together as a unit and the registration rights agreement could require significant liquidated damages be paid to the holder of the instrument in the event the issuer fails to register the underlying shares issuable upon conversion under a preset timeframe, or in some cases, where the issuer does not maintain an effective registration statement with a current prospectus for a preset time period.

In the first case above, since there is no explicit limit on the number of shares that are to be delivered upon exercise of the conversion feature, the registrant is not able to assert that it will have sufficient authorized and unissued shares to settle the conversion option. As a result, the
conversion feature would be accounted for as a derivative liability, with changes in fair value recorded in earnings each period. Additionally, registrants should note that a variable share settled instrument that results in liability classification may impact the classification of previously issued instruments, as well as instruments issued in the future.

Registrants should ensure they have appropriately analyzed all terms contained in their convertible preferred stock and convertible debt agreements, including any other embedded features that could require bifurcation under SFAS 133, for example, puts, calls, contingent interest features, etc. Registrants should ensure all of these features have been appropriately identified, accounted for, valued, and disclosed.

C. Statement of Cash Flows (Updated)

The statement of cash flows is one of the primary statements required with a full set of financial statements. It is relied upon by analysts and investors as much, if not more in some instances, as the statement of net income. The importance of appropriate classification and presentation of items in the consolidated statement of cash flows cannot be overstated. Registrants should give sufficient attention to the preparation of their consolidated statement of cash flows in order to ensure it provides an accurate presentation of their actual cash receipts and cash payments based on activity (operating, investing and financing), which in turn assists the reader in determining the registrant's ability to meet its obligations, pay dividends, generate cash flows sufficient to grow its business, etc.

FASB Statement No. 95, Statement of Cash Flows, provides guidance on appropriate classification of cash flows with the goal of improving the comparability across companies in classifying similar items. The staff has noted diversity in practice in the classification of cash flows related to several activities, a few of which are noted below. In situations where a registrant believes they have chosen an acceptable classification but has identified diversity in practice or believes a different classification may also be acceptable, the registrant should provide quantified disclosure that is sufficient to inform investors of the classification chosen and the alternative classification considered and rejected.

While the staff believes a statement of cash flows using the direct method provides investors with more useful information than the indirect method, we recognize that most registrants use the indirect method. Therefore, we encourage registrants to put sufficient time and effort into ensuring that the statement of cash flows, and related disclosure in the financial statement footnotes and in MD&A, is meaningful and useful to users of the financial statements.

1. Discontinued Operations (New)

An increasing number of registrants are reporting discontinued operations, based on the criteria of FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. Because of this increased frequency, the staff has become aware of a wide diversity in practice of reporting cash flows from discontinued operations in the cash flow statements. While
the notion of identifiable cash flows is integral to the model, SFAS 144 is silent with respect to
reporting the cash flows associated with the discontinued operations.

SFAS 95 requires that an entity report its cash inflows and outflows according to whether
they relate to operating, investing, or financing activities. Footnote 10 of the statement
specifically addresses discontinued operations and says that separate disclosure of cash flows
pertaining to discontinued operations reflected in the operating, investing, and financing
categories is not required. The footnote continues and states that an enterprise that nevertheless
chooses to report separately operating cash flows of discontinued operations shall do so
consistently for all periods affected.

While there are variations in cash flow presentation for discontinued operations, the staff
believes the key consideration is whether they conform to the basic disclosure requirement in
FAS 95 that all cash flows be reported as relating to either operating, investing, or financing
activities. Some of the variations that appear to be consistent with this disclosure requirement
include:

- Combining the cash flows generated from discontinued operations with the cash
  flows from continuing operations within each of the 3 categories;
- Separately identifying the cash flows related to discontinued operations within
each of the 3 categories, or just separately for operating cash flows; and,
- Displaying the cash flows related to discontinued operations separately for
  operating, investing and financing activities near the bottom of the statement, just
  before "net increase or decrease in cash and cash equivalents."

SFAS 95 does not appear to support aggregating operating, investing, and financing cash
flows from discontinued operations into a single line item, as some registrants have presented.
Also, FAS 95 does not appear to support presenting cash flows from operating, investing, and
financing activities of the discontinued operations all within the operating cash flow category.

Registrants who have discontinued operations should carefully consider how to present
disclosures about their cash flows within the Liquidity and Capital Resources section of MD&A.
Management should pay particular attention to describing how cash flows from discontinued
operations are reflected in their cash flows statements, and, if material, they should quantify
those cash flows if they are not separately identified in those statements. In addition,
management should describe how it expects the absence of cash flows, or absence of negative
cash flows, related to the discontinued operations to impact the company's future liquidity and
capital resources, and should discuss any significant past, present, or upcoming cash uses as a
result of discontinuing the operation.

2. Insurance Proceeds (New)

Registrants often receive cash payments for claims related to various insurance policies. The
question that frequently arises is whether the cash flow should be presented in the cash flow

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statement according to the activity that resulted in the insurance proceeds or the activity for which the registrant intends to use the insurance proceeds.

Paragraph 22c of SFAS 95 states that proceeds of insurance settlements should be classified as operating cash inflows, except for proceeds that are directly related to investing or financing activities. It provides an example that proceeds received from the destruction of a building would be classified as an investing cash inflow.

This guidance seems to suggest that proceeds from insurance settlements should be classified based on the nature of the insurance coverage which resulted in the right to receive payment. Said differently, classification of the cash inflow is based on the nature of the loss that is covered by the registrant’s insurance policy. Classification of the proceeds is not affected by how a registrant spends, or plans to spend, those proceeds. So, for example, proceeds received under a business interruption policy would be classified within operating activities. Classification of proceeds received under a policy that protects against damage to, or loss of, property depends on the nature of the covered property. Recovery on fixed assets owned or leased under capital leases would be an investing activity, and settlements related to inventory, for example, would be an operating activity.

Material cash settlements should also be discussed in MD&A to inform investors of cash received and why it was received, what the company plans to do with the proceeds, how it is presented on the cash flows statement, and the impact, if any, on reported earnings.

**D. Oil and Gas (Updated)**

Staff reviews have uncovered diversity in practice among registrants in the oil and gas industry in the areas of buy/sell transactions and capitalization of exploratory drilling costs. As a result, the staff issued letters to registrants in the oil and gas industry in February 2005; see the letter at [http://www.sec.gov/divisions/corpfin/guidance/oilgas021105.htm](http://www.sec.gov/divisions/corpfin/guidance/oilgas021105.htm). The EITF and the FASB subsequently addressed the areas of buy/sell transactions (see section II.F.1. of this outline) and capitalization of exploratory drilling costs (see FSB No. FAS 19-1, *Accounting for Suspended Well Costs*). As a result of the activity of the standard setters in these areas, the related guidance in staff’s February 2005 letter is no longer applicable although registrants should continue to consider the need for disclosure in the financial statement footnotes and MD&A.

The February 2005 letter also discusses the staff’s consideration of the accounting for a property disposition by a registrant using the full cost method that resulted in a less than 25% alteration of the proved oil and gas reserve quantities within a cost center and whether goodwill should be allocated to the property disposed. Goodwill associated with acquisitions of oil and gas properties that constitute a business is recognized in accordance with FASB Statement No. 141, *Business Combinations*, but accounted for outside of the full cost rules. Therefore, when dispositions of these properties occur, the goodwill previously recognized does not affect the adjustments contemplated under Rule 4-10(c)(6)(i) of Regulation S-X. Rather, the accounting for the goodwill and any potential impairment should follow the provisions of FASB Statement
No. 142, *Goodwill and Other Intangible Assets*. Registrants should consider whether a property disposition that results in a less than 25% alteration of the proved oil and gas reserve quantities within a given cost center is a trigger that requires goodwill be evaluated for impairment under SFAS 142.

**E. Leasing**

1. **Accounting**

There have been a number of restatements for lease accounting in the following areas: (1) the amortization of leasehold improvements by a lessee in an operating lease with lease renewals, (2) the pattern of recognition of rent when the lease term in an operating lease contains a period where there are free or reduced rents (commonly referred to as “rent holidays”), and (3) incentives related to leasehold improvements provided by a landlord/lessor to a tenant/lessee in an operating lease. The Commission’s Office of Chief Accountant recently issued a letter outlining the current GAAP literature that should be looked to in determining the appropriate accounting. See the letter at: [http://www.sec.gov/info/accountants/staffletters/cpcaf020705.htm](http://www.sec.gov/info/accountants/staffletters/cpcaf020705.htm)

2. **Disclosure**

Registrants should review the completeness and accuracy of disclosures concerning both operating and capital lease accounting to address the material terms of and accounting for leases. The disclosure should be concise and to the point. Basic descriptive information about material leases, usual contract terms, and specific provisions in leases relating to rent increases, rent holidays, contingent rents, and leasehold incentives may be best addressed in the description of properties or business section. In addition to the disclosures required by FASB Statement No. 13, *Accounting for Leases*, and FASB Statement No. 29, *Determining Contingent Rentals*, and related interpretations, the accounting for leases should be clearly described in the notes to the financial statements, such as the accounting policy footnote, and in the discussion of critical accounting policies in MD&A as appropriate. Known or likely trends or uncertainties in future rent or amortization expense that could materially affect operating results or cash flows should be addressed in MD&A. Some disclosure examples follow:

- Describe material lease agreements or arrangements clearly;
- Disclose the essential provisions of material leases, including the original term, renewal periods, rent escalations, rent holidays, contingent rent, rent concessions, leasehold improvement incentives, and unusual provisions or conditions;
- Describe the accounting treatment for leases, to address each of the above components of lease agreements;
- Disclose the basis on which contingent rental payments are determined with specificity, not generality;
- Disclose the specific period used to amortize material leasehold improvements made either at the inception of the lease or during the lease term.
F. Revenue

1. Buy/Sell Arrangements (Updated)

In 2005 the staff issued letters to certain registrants on several issues, including the accounting, presentation, and disclosure of buy/sell transactions. While the letters were issued to registrants in the oil and gas industry, there may be registrants in other industries who engage in comparable transactions. Buy/sell transactions typically involve contractual arrangements that establish the terms of the agreements to buy and sell a commodity either jointly in a single contract, or separately in individual contracts that are entered into concurrently or in contemplation of one another with a single counterparty. There may be provisions accommodating differences in quantities or grades, receipt and delivery locations, and stipulating that monetary consideration accompany the exchange. Such arrangements may be employed to facilitate the procurement of feedstock for a refinery operation, or to otherwise manage the supply chain or inventory generally. Some registrants may find it necessary to enter into a series of these transactions with different counterparties in an effort to obtain a given quantity of feedstock or inventory for a single location. We understand that these arrangements are undertaken due to market forces of supply and demand, and may serve to increase the efficiency with which transportation assets are utilized, or to reduce the overall cost of acquiring inventory.

In September 2005, the EITF issued EITF No. 04-13, Accounting for Purchases and Sales of Inventory with the Same Counterparty to provide guidance on whether some or all of these buy/sell arrangements should be accounted for as a single exchange transaction within the scope of Accounting Principles Board Opinion No. 29, Accounting for Nonmonetary Transactions. The EITF consensus also addressed whether there are any circumstances under which nonmonetary exchanges of inventory within the same line of business should be recognized at fair value.

2. Service Contracts and the use of SOP 81-1

AICPA Statement of Position 81-1, Accounting for Performance of Construction/Production Contracts, specifically scopes out most service transactions. Footnote 1 of the SOP discusses its application to separate contracts to provide services essential to the construction or production of tangible property, such as design, engineering, procurement, and construction management. Nonetheless, long-term service contracts are not substantially different from other revenue arrangements. In determining whether delivery has occurred, registrants should pay careful attention to the terms of the arrangement, specifically the rights and obligations of the service provider and the customer. Provided all other revenue recognition criteria have been met, the revenue recognition method selected should reflect the pattern in which the obligations to the customer are fulfilled.

For example, in situations where a registrant cannot apply SOP 81-1 to their service contracts, a revenue recognition model that recognizes revenue as the service is performed using a proportional performance model, as contemplated by SAB Topic 13, is an often acceptable
model. An output-based approach would generally be utilized. An input-based approach may be acceptable where the input measures are a reasonable surrogate for output measures. However, a cost-to-cost approach to revenue recognition is generally not appropriate outside the scope of SOP 81-1 since it rarely gives a good estimate of proportional performance.

3. Disclosure

Since revenue recognition is often a critical accounting policy, registrants should review the completeness and accuracy of disclosures concerning their sources of revenues, method of accounting for revenues, and material considerations in evaluating the quality and uncertainties surrounding their revenue generating activity. The disclosure should be concise and to the point; more disclosure is not necessarily better. Basic descriptive information about revenue generating activities, customary contract terms and practices, and specific uncertainties inherent in the registrant’s business activities may be most appropriate in Description of Business. Descriptive information about the effects of variations in revenue generating activities and practices, or changes in the magnitude of specific uncertainties, is most appropriate in MD&A. Accounting policies, material assumptions and estimates, and significant quantitative information about revenues should be included in notes to the financial statements or in MD&A, as appropriate. Some disclosure examples follow:

**Disaggregate product and service information**

- Report product and service revenues (and costs of revenues) separately on the face of the income statement
- Furnish separate revenues of each major product or service within segment data
- Describe the major revenue-generating products, services, or arrangements clearly
- For major contracts or groups of similar contracts, disclose essential terms, including payment terms and unusual provisions or conditions

**Disclose when revenue is recognized (examples)**

- Upon delivery (indicate whether terms are customarily FOB shipping point or FOB destination)
- Upon completion of service
- After commencement of service, ratably over service period
- Upon satisfaction of a significant condition of sale – (identify the condition)
  - Only after customer acceptance?
  - Only after testing?
- Upon completion of all terms of contract
- Over performance period based on progress toward completion
- Upon delivery of separate elements in multi-element arrangement

*If revenue is recognized over the service period, based on progress toward completion, proportional performance, or based on separate contract elements or milestones, disclose how the period’s revenue is measured.*
• Disclose how progress is measured (cost to cost, time and materials, units of delivery, units of work performed)
• Identify types of contract payment milestones, and explain how they relate to substantive performance and revenue recognition events
• Disclose whether contracts with a single counterparty are combined or bifurcated
• Identify contract elements permitting separate revenue recognition, and describe how they are distinguished
• Explain how contract revenue is allocated among elements
  o Relative fair value or residual method?
  o Fair value based on vendor specific evidence or by other means?

**Disclose material assumptions, estimates and uncertainties**

• Disclose contingencies such as rights of return, conditions of acceptance, warranties, price protection, etc.
• Describe the accounting treatments for the contingencies
• Describe significant assumptions, material changes, and reasonably likely uncertainties
• Special disclosures and conditions are specified by SAB Topic 13 for companies that recognize refundable revenues by analogy to FASB Statement No. 48, *Sales With the Right of Return.*

**G. Business Combinations**

1. **Purchase Price Allocation and Use of Residual Method**

   SFAS 141 requires that the cost of an acquired entity be allocated to the assets acquired and the liabilities assumed based on their fair value at the acquisition date. Any residual of the purchase price in excess of the identified assets and liabilities is accounted for as goodwill. Because SFAS 141 eliminates the requirement to amortize goodwill, it is important for registrants to ensure they are identifying all intangible assets acquired rather than inappropriately adding their value to goodwill if unidentified.

   Staff reviews have uncovered registrants that allocated the excess purchase price to an intangible asset rather than goodwill, under the premise that the intangible asset could not be separately valued because it is indistinguishable from goodwill. However, this method, called the residual method, does not comply with SFAS 141 which requires that intangible assets that meet the recognition criteria be recorded at fair value. As a result, the SEC staff made a Staff Announcement, No. D-108, *Use of the Residual Method to Value Acquired Assets Other Than Goodwill,* at the September 2004 EITF meeting. EITF D-108 states that the residual method should no longer be used to value intangible assets other than goodwill. Rather, intangible assets should be separately and directly valued and the resulting fair value recognized. Registrants that
have applied the residual method to the valuation of intangible assets should refer to EITF D-108 for transition guidance.

2. **Date of Annual Goodwill Impairment Testing**

SFAS 142 requires that goodwill be tested, at the reporting unit level, for impairment on an annual basis. An impairment test also could be triggered between annual tests if an event occurs or circumstances change. A reporting unit is required to perform the annual impairment test at the same time every year, however, nothing precludes a registrant from changing the date of the annual impairment test. If a registrant chooses to change the date of the annual impairment test, it should ensure that no more than 12 months elapse between the tests. The change in testing dates should not be made with the intent of accelerating or delaying an impairment charge. The staff will likely raise concerns if a registrant is found to have changed the date of its annual goodwill impairment test frequently.

Any change to the date of the annual goodwill impairment test would constitute a change in the method of applying an accounting principle, as discussed in paragraph 4 of SFAS 154, and therefore would require justification of the change on the basis of preferability. The registrant is required by Rule 10-01(b)(6) of Regulation S-X to disclose the date of and reason for the change. The registrant is also required by Item 601 of Regulation S-K to file, as an exhibit to the first Form 10-Q or 10-QSB after the date of the change, a letter from the registrant’s independent registered public accounting firm indicating whether or not the change is to an alternative principle which in his judgment is preferable under the circumstances. See Staff Accounting Bulletin Topic 6.G.2.b. for additional guidance.

**H. Investments**

1. **Other-Than-Temporary Declines in Value (Updated)**

Temporary declines in the value of debt securities held-to-maturity are not recognized in earnings; temporary declines in value of available-for-sale debt and equity securities are netted with unrealized gains and reported as a net amount in a separate component of shareholder’s equity. However, a decline in fair value below amortized cost that is other than temporary is accounted for as a realized loss. FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, specifies that "[i]f the decline in fair value is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value… and the amount of the write down shall be included in earnings.” This write down results in a new cost basis for the security, which cannot be recovered if the fair value subsequently increases.

Bright line or rule of thumb tests are not appropriate for evaluating other-than-temporary impairments. The determination of whether a decline is other than temporary must be made using all evidence that is available to the investor, and not just that related to the registrant such as its financial condition and near-term prospects, but also the severity and duration of the decline in fair value and the investor’s intent and ability to hold an investment for a reasonable...
period of time sufficient for a forecasted recovery. Guidance in evaluating whether a security’s recent decline in value is other than temporary has in the past only been found in SAB Topic 5:M, Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities.

In November 2003, the EITF issued No. 03-01, Other-Than-Temporary Impairments, and in November 2005, the FASB issued FSP Nos. FAS 115-1 and FAS 124-1, The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments, which amends certain portions of EITF 03-01. EITF 03-01 and FSP Nos. FAS 115-1 and FAS 124-1 are similar to the staff’s historical analysis discussed above. The guidance requires disclosures addressing impairments in a qualitative and quantitative manner.

Since the typical equity security does not have a contractual cash flow at maturity on which to rely, an investor’s intent and ability to hold an equity security for a reasonable period of time should be analyzed differently than a typical debt security. The ability to hold an equity security indefinitely would not, by itself, allow an investor to avoid an other-than-temporary impairment.

As a practical matter there are limitations on the period of time that management can incorporate into its forecast of market price recoveries. As the forecasted market price recovery period lengthens, the uncertainties inherent in management’s estimate increase, which impact the reliability of that estimate. Market price recoveries that cannot reasonably be expected to occur within an acceptable forecast period should not be included in the assessment of recoverability.

A recognized or potential other than temporary impairment may require discussion in MD&A, if material, if it is considered to be a known material event or uncertainty, an unusual or infrequent event or transaction, or necessary to an understanding of financial condition or results of operations. Some items to consider in an MD&A discussion, including discussion of critical accounting policies, include the amount of the charge, the underlying reasons for the charge and its timing, an identification of which segment the charge relates to, whether or not it is included in the segment’s profit or loss measure under FASB Statement No. 131, Disclosures about Segments of an Enterprise and Related Information, potential risk and uncertainties regarding future declines, and the estimated effects that material declines would have on the registrant’s liquidity.

In several Accounting and Auditing Enforcement Releases, e.g., In the Matter of Fleet/Norstar, AAER No. 29557; In the Matter of Excel Bancorp, Inc., AAER No. 29675; In the Matter Abington Bancorp, Inc., AAER No. 30614; and In the Matter of Presidential Life Corporation, AAER No. 31934, the Commission has taken action in instances when other than temporary declines in value were not reported in a timely and appropriate fashion. In these releases, the Commission observed that a registrant’s assessment of the realizable value of a marketable security should begin with its contemporaneous market price because that price reflects the market’s most recent evaluation of the total mix of available information. Objective evidence is required to support a realizable value in excess of a contemporaneous market price. That information may include the company’s financial performance (including such factors as earnings trends, dividend payments, asset quality, and specific events), the near term prospects of
the company, the financial condition and prospects of the company’s region and industry, and the registrant’s investment intent.

Additionally, the releases state that the Commission expects registrants to employ a systematic methodology that includes documentation of the factors considered. The methodology should ensure that all available evidence concerning declines in market values below cost are identified and evaluated in a disciplined manner by responsible personnel. Auditors are reminded of the need to closely examine the documentation concerning their client’s determinations of other than temporary declines in market values.

2. Government-Sponsored Enterprises

Government-Sponsored Enterprises (GSEs), such as Fannie Mae, Freddie Mac and the Federal Home Loan Banks, issue marketable debt to the public. In addition, Fannie Mae and Freddie Mac have publicly held common stock and also issue guaranteed mortgage-backed securities to the public. None of the debt securities issued by any of these GSEs is backed by the full faith and credit of the United States government. Section II of Industry Guide 3 requires disclosure of the book value of a bank holding company’s investment portfolio based on specified categories of obligations, such as obligations of the U.S. Treasury and obligations of States of the U.S. Because the GSE obligations are not backed by the full faith and credit of the United States government, registrants should not disclose these investments aggregated with the Industry Guide 3 category, obligations of the U.S. Treasury. Separate categorization of these obligations is appropriate, as their nature is not consistent with any of the categories currently listed in Industry Guide 3. Registrants should consider similar disclosure categorization when providing disclosure pursuant to SFAS 115 and FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments.

3. Auction Rate Securities

Auction rate securities are long-term variable rate bonds tied to short-term interest rates that are reset through a “dutch auction” process which occurs every 7 – 35 days. The holder can participate in the auction and liquidate the auction rate securities to prospective buyers through their broker/dealer. The holder does not have the right to put the security back to the issuer.

Auction rate securities are considered highly liquid by market participants because of the auction process. However, because the auction rate securities have long-term maturity dates and there is no guarantee the holder will be able to liquidate its holdings, these securities do not meet the definition of cash equivalents in paragraphs 8 and 9 of SFAS 95. Registrants should refer to SFAS 115 to determine the proper accounting and SFAS 95 to determine the proper classification on the Statement of Cash Flows. To determine if the auction rate securities should be presented on the balance sheet as current or noncurrent assets, registrants should refer to ARB No. 43, Chapter 3A, Working Capital – Current Assets and Current Liabilities.
I. Contingencies, Loss Reserves, and Uncertain Tax Positions (Updated)

1. Accounting and Financial Statement Disclosure

SFAS 5, Accounting for Contingencies, requires accrual of payments for contingent liabilities if payment is both probable and estimable. SFAS 5 also requires disclosure of the nature of any contingency, including the amounts that might be paid, if a loss is at least reasonably possible. Other literature also provides accounting and disclosure guidance, such as Staff Accounting Bulletin Topic 5.Y., Accounting and Disclosures Relating to Loss Contingencies, FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss, and AICPA Statement of Position 94-6, Disclosure of Certain Significant Risks and Uncertainties.

Registrants, their auditors, and their advisors have a responsibility to critically assess the claims against the company in order to identify those for which losses should be accrued and those that are not accrued because the success of the claim is only reasonably possible. Disclosure should discuss the nature of the claim, the amount accrued, if any, and the possible range of loss for claims where any amount within the range of reasonably possible loss is material. Circumstances where a loss was accrued for a claim without disclosure in prior filings of the nature of the claim and the range of reasonably possible loss should be rare due to the nature of most contingencies. A registrant that accrues a significant loss for a contingency, but whose prior disclosure of the low end of the range of reasonably possible loss was zero with no loss accrued, should ensure that there is robust disclosure that explains what triggered the significant loss in the period in which it was recorded.

While income tax contingencies no longer fall within the scope of SFAS 5, FIN 48 provides disclosure requirements related to uncertain tax positions. FASB Statement No. 109, Accounting for Income Taxes, also provides disclosure requirements for income tax items that arise as a result of temporary differences. As with other contingencies, such as litigation contingencies, registrants need to balance concerns regarding confidentiality with the need for the registrant’s investors, analysts, and regulators to gain a clear understanding of the registrant’s liquidity, as well as results of operations and financial position, through footnote disclosure and discussions in MD&A.

2. Discussion in MD&A (New)

The requirement to discuss uncertainties in MD&A encompasses both financial and non-financial factors that may influence the business, either directly or indirectly. In many cases, there will be current or immediate accounting implications associated with an uncertainty, as occurs when the likelihood of a loss contingency becomes probable and the amount of loss is reasonably estimable. However, the need to discuss such matters in MD&A will often precede any accounting recognition when the registrant becomes aware of information that creates a reasonable likelihood of a material effect on its financial condition or results of operations, or when such information is otherwise subject to disclosure in the financial statements, as occurs
when the effect of a material loss contingency becomes reasonably possible. If a registrant is unable to estimate the reasonably likely impact, but a range of amounts are determinable based on the facts and circumstances surrounding the contingency, it should disclose those amounts.

Many individual loss contingencies can have particular characteristics and uncertainties that would make aggregated disclosure insufficient to provide material information necessary to an understanding of the loss contingency position. Companies should consider whether it is necessary to discuss loss contingencies on both an aggregated and disaggregated basis.

Common loss contingencies involve product warranties and defects, guarantees of indebtedness, indemnification provisions, claims or assessments, environmental contamination, and other pending or threatened litigation. The discussion and analysis should include a quantification of the related accruals and adjustments, costs of legal defense, and reasonably likely exposure to additional loss, as well as the assumptions management has made concerning those amounts. If a registrant provides indemnification for matters associated with a discontinued operation, and management determines it is reasonably likely the company will incur a material liability, MD&A should discuss the relevant terms of the indemnification, including the duration of the agreement and the extent of coverage or exposure.

A company should articulate the reasons the assumptions it used best reflect its exposure, and the extent to which the resulting estimates of loss are sensitive to changes in those assumptions. The need to address the underlying assumptions is especially important when there is a material difference between the range of reasonably possible loss and the amount accrued. Due to the extent of judgment involved in assessing probability and estimating loss, MD&A should also address the timing of the accounting effects to properly convey information about variability. The discussion should indicate when the underlying event associated with a loss contingency occurred and describe the developments during the intervening periods which resulted in the establishment or adjustment of accruals.

J. Pension, Post Retirement, and Post Employment Plans

1. Selection of Discount Rates under FASB Statement Nos. 87 and 106

FASB Statement No. 87, *Employers’ Accounting for Pensions*, and FASB Statement No. 106, *Employers’ Accounting for Postretirement Benefits Other Than Pensions*, require that the calculation of a projected benefit obligation include a discount rate that reflects the rates at which the pension benefits could effectively be settled. Conceptually, the selection of an assumed discount rate should be based on the single sum that, if invested at the measurement date, would generate the necessary cash flows to pay the benefits when due (see paragraph 186 of SFAS 106). As discussed in EITF Topic D-36, one method for determining the assumed discount rate is to create a hypothetical portfolio of high quality bonds (rated Aa or higher by a recognized rating agency) for which the timing and amount of cash outflows approximates the estimated payouts of the defined benefit plan.
The staff expects registrants with material defined benefit plans to include clear disclosure of how it determines its assumed discount rate, either in the financial statement footnotes or in the critical accounting policies section of MD&A. That disclosure should include the specific source data used to support the discount rate. If the registrant benchmarks its assumption off of published long-term bond indices, it should explain how it determined that the timing and amount of cash outflows related to the bonds included in the indices matches its estimated defined benefit payments. If there are differences between the terms of the bonds and the terms of the defined benefit obligations (for example if the bonds are callable), the registrant should explain how it adjusts for the difference. Increases to the benchmark rates should not be made unless the registrant has detailed analysis that supports the specific amount of the increase.

2. Disclosure

Item 303(a) of Regulation S-K requires the disclosure of any known trends, demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant’s liquidity increasing or decreasing in any material way, or which would cause reported financial information not to be necessarily indicative of future operating performance or future financial condition. The discussion of employee benefit plans in MD&A should provide readers with information regarding the following to the extent material:

- the nature of the plans,
- the character of deferred gains and losses,
- the degree to which important assumptions have coincided with actual experience, and
- the timing and amounts of future funding requirements.

The discussion and analysis of employee benefits should also provide readers with information regarding the following to the extent material:

- the effects of accounting for the registrant’s benefit plans and
- the funding of the accumulated and projected benefit obligations on the registrant’s financial condition and operating performance.

Assumptions and Estimates

The accounting for employee benefit plans typically involves numerous assumptions and estimates, and frequently the use of experts such as actuaries in determining asset allocations and quantifying benefit obligations, funding requirements, and compensation expense. The accounting standards for pension and post-retirement plans also involve mechanisms that serve to limit the volatility in earnings, which would otherwise result from recording changes in the value of plan assets and benefit obligations in the financial statements in the periods in which such changes occur.

MD&A should identify the following:
material assumptions underlying the accounting for benefit plans, and  
changes to those assumptions having a material effect on financial condition and operating performance.

Registrants should ensure that the disclosure of their accounting policies and other footnote disclosure in the financial statements are comprehensive and minimize unnecessary repetition of information in MD&A.

**Changes to Assumptions and Estimates**

A registrant should consider the impact of its various assumptions, to determine the extent to which the assumptions or changes in the assumptions have a material effect, including those concerning:

- the long-term rates of return on plan assets,
- discount rates used for projecting benefit obligations,
- methods of deriving market-related value,
- average remaining service period,
- average remaining life expectancy, and
- any alternate methods of amortizing gains and losses selected.

While some of these assumptions are subject to frequent revision, others may be relatively static. In describing material changes to the assumptions, it may be necessary to indicate how often revisions are made.

**Comparison of Actual and Expected results**

Accounting for employee benefit plans is largely dependent on the assumptions concerning the periods of attribution (the process of assigning the cost of benefits to period of employee service) and the calculation and amortization of gains and losses. Therefore, MD&A should address the material trends or patterns of amounts reflected in the financial statements, significant assumptions and any material variations between the results based on those assumptions, and the registrant’s actual experience. For example, when results of operations are materially impacted by benefit plans, the registrant should disclose the material underlying assumptions and their effect to sufficiently address the quality of the registrant’s earnings. In addition, when material deviations between the actual and expected long-term rates of return on plan assets arise, those amounts should be disclosed, as should any material deferred gains or losses that result. Under these circumstances, a registrant should quantify the amounts, and indicate the periods in which these will be reflected in the results of operations.

When addressing the expected and actual long-term rates of return on plan assets, registrants should disclose, where material:

- the various categories of investments held as plan assets,
- the relative asset allocations or holdings in each category, and
- any reasonably likely changes in the allocation of plan assets.
A sensitivity analysis, demonstrating how a change in the assumed long-term rates of return would impact the results of operations, may also be necessary to sufficiently convey the quality of the registrant’s earnings and the degree of uncertainty. If deferred gains and losses are material, a registrant should discuss the amortization periods, while differentiating between gains and losses that are subject to amortization and those that are not.

Other disclosures in MD&A related to benefit plans, including those related to exposure, recognition and funding obligations, should follow a similar approach. MD&A should build on and not unnecessarily repeat information disclosed in the notes to the financial statements. Registrants should disclose material assumptions and changes in assumptions, the resulting material effect on financial condition and operating performance, material deviations between results based on the assumptions used by registrants and actual plan performance, and the known material trends and uncertainties relating to plans, including those caused by these deviations. For example, registrants should consider whether disclosure of the historical pattern of expense recognition and the periods over which any amounts deferred in other comprehensive income will be recognized in results of operations is necessary.

**Funding Obligations**

If there are material funding obligations, a registrant should:

- quantify the amounts of the funding obligations,
- address the material known trends or uncertainties relating to paying such amounts (for example, if the registrant expects to pay them over a specified period of time, or if there are known material uncertainties concerning payment),
- address the material impact of future payments on future cash flows, and
- address any material uncertainty in the funding obligation itself (for example, uncertainty introduced by significant differences between the duration of debt instruments included in plan assets, or changing demographics in the workforce, and the expected timing of future benefit payments).

The funding of pension obligations is influenced by several factors, among them, voluntary contributions and funding requirements determined by ERISA and the IRS. The required contribution is a calculated amount, which increases for certain underfunded plans in the form of a deficit reduction contribution and could be decreased if excess funding credits are available. Registrants who are experiencing financial difficulty may conclude that there is significant uncertainty surrounding future funding of pension obligations, primarily due to the possibility of bankruptcy which in turn could result in the termination of the pension plan. Registrants whose future funding is uncertain due to financial difficulty should disclose the nature of the uncertainty and a range of reasonably possible future funding, which may include disclosure of the statutory termination obligation.

**K. FIN 46 and Deconsolidation**
The FASB issued FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, in January 2003 and revised it with FIN 46R in December 2003. The purpose of FIN 46 is to provide guidance on consolidation of certain kinds of entities. Although FIN 46 resulted in consolidation of many previously off-balance sheet structures, it also resulted in deconsolidation of certain subsidiary trusts that issue trust preferred securities. This deconsolidation has in turn raised the question of whether issuers of trust preferred securities may continue to provide the modified financial information permitted by Rule 3-10 of Regulation S-X, which presumes that consolidation is the basis for the 100% owned requirement in that rule. The staff believes that FIN 46 will not affect the ability of finance subsidiaries issuing trust preferred securities to avail themselves of Rule 3-10(b) of Regulation S-X and Exchange Act Rule 12h-5 if the finance subsidiaries meet the conditions of that paragraph and provide the following footnote disclosure:

- an explanation of the transaction between the parent and the subsidiary that resulted in debt appearing on the books of the subsidiary,
- a statement of whether the finance subsidiary is consolidated. If the finance subsidiary is not consolidated, an explanation why, and
- if a deconsolidated finance subsidiary was previously consolidated, and explanation of the effect that deconsolidation had on the financial statements

However, registrants should remember that consolidation in the parent’s financial statements is a requirement for operating subsidiaries that seek to avail themselves of the modified reporting provided by paragraphs (c) through (f) of Rule 3-10.

**L. Segment Disclosure**

SFAS 131 became effective for fiscal years beginning after December 15, 1997. One significant focus of staff reviews continues to be the evaluation of whether registrants have complied completely with all the disclosure requirements of SFAS 131.

1. **Identification of Operating Segments**

SFAS 131 defines an operating segment, in part, as a component of an enterprise whose operating results are regularly reviewed by the chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance. Operating segments may be aggregated in the disclosure only to the limited extent permitted by the standard. If operating segments are aggregated, that fact must be disclosed. Under SFAS 131, the chief operating decision maker is not necessarily a single person, but is a function that may be performed by several persons.

If the chief operating decision maker receives reports of a component’s operating results on a quarterly or more frequent basis, the staff may challenge a registrant’s determination that the component is not an operating segment for purposes of SFAS 131 unless reports of other overlapping sets of components are more clearly representative of the way the business is managed. On a few occasions, the staff has requested copies of all reports furnished to the chief
operating decision maker if the reported segments did not appear realistic for management’s assessment of a registrant’s performance or conflicted with that officer’s public statements describing the registrant. The staff also has reviewed analyst’s reports, interviews by management with the press, and other public information to evaluate consistency with segment disclosures in the financial statements. Where that information revealed different or additional segments, amendment of the registrant’s filings to comply with SFAS 131 was required.

2. Aggregation of Operating Segments (Updated)

SFAS 131 allows for aggregation of operating segments that sell similar products or services created with similar production processes to similar customers using similar distribution systems in similar regulatory environments, and that have similar economic characteristics. These criteria are listed in paragraph 17 of SFAS 131, along with the requirement that aggregation must be consistent with the objectives and principles of the standard. The staff believes aggregation is a high hurdle and is appropriate only in situations where, as stated by the FASB in the basis for conclusions to SFAS 131, “separate reporting of segment information will not add significantly to an investor’s understanding of an enterprise [because] its operating segments have characteristics so similar that they can be expected to have essentially the same future prospects.” The FASB rejected recommendations that the aggregation criteria be indicators rather than tests. Therefore, after a company identifies their operating segments, aggregation is only allowed if the identified operating segments meet all of the aggregation criteria, with the resulting segments being reported if they meet the significance test in paragraph 19 of the standard.

The staff has also seen improper aggregation in situations involving a quantitatively immaterial segment. The staff has seen instances where a quantitatively immaterial segment is aggregated with a reportable segment because it does not meet the quantitative thresholds requiring separate presentation. If the quantitatively immaterial segment does not share a majority of the aggregation criteria with the reporting segment, aggregation is inappropriate. In this situation, the quantitatively immaterial operating segment would best be placed into the “other” category.

3. Other Compliance Issues

Registrants should remember to identify the products and services from which each reportable segment derives its revenues, and to report the total revenues from external customers for each product or service or each group of similar products and services. Disclosures for products and services that are not substantially similar must be disaggregated. The staff has objected to overly broad views of what constitutes similar products. In its assessment of whether dissimilar products have been aggregated, the staff may review public disclosures and marketing materials that describe the registrant’s products.

Information about geographic areas is also required to be disclosed based on countries, both the country of domicile and for foreign countries. If a registrant manages its business by geographic regions and determines its reportable segments accordingly, it still must provide the
separate geographic disclosures for each country in which revenues are material. Some registrants provide this disclosure by presenting material countries separately within the subtotals by region.

The reconciliation of segment elements to the consolidated financial statements should quantify and clearly explain each material reconciling item. Effects of measurement differences should be identified, and asymmetrical allocations among segments should be highlighted.

4. Changes in segments

The requirement to recast prior information to correspond with current reportable segments, or to otherwise provide comparable information, is discussed in paragraphs 34 and 35 of SFAS 131. Effects of changes in significance of reportable segments are discussed in paragraphs 22 and 23. If management changes the structure of its internal organization after fiscal year end, or intends to make a change, the new segment structure should not be presented in financial statements until operating results managed on the basis of that structure are reported. Disclosures based on the historical reportable segments should be presented until financial statements for periods managed on the basis of the new organizational structure are presented. However, supplemental disclosure of the future effects of the changes may be useful.

If annual financial statements are required in a registration statement or proxy statement that includes subsequent periods managed on the basis of the new organizational structure, the annual audited financial statements should include a revised segment footnote that reflects the new reportable segments. The registrant’s Description of Business and MD&A should be similarly revised. Prior filings that reported the old organizational structure should not be amended. The revised annual financial statements and related disclosures may be included in the registration or proxy statement or in a Form 8-K incorporated by reference. If a registrant files a Form S-3 or Form S-8 that incorporates its most recent Forms 10-K and 10-Q before the new organizational structure is required to be presented in the financial statements, management and their advisors should consider whether the change in reportable segments is a material change per Item 11 of Form S-3 or General Instruction G.2. of Form S-8, respectively. If the change in reportable segments is deemed to be a material change, the registrant should report recasted segment information prior to the effective date of the Form S-3 or Form S-8.

5. Operating segments and goodwill impairment (New)

The provisions of FASB Statement No. 142, Goodwill and Other Intangible Assets, mean that the appropriate identification of operating segments has ramifications that now extend beyond disclosures alone. Paragraph 18 of SFAS 142 requires that goodwill be tested for impairment at the reporting unit level. Reporting units are defined in paragraph 30 of SFAS 142 as either an operating segment as defined in SFAS 131 or one level below an operating segment, referred to as a component.

A registrant must go to the component level if the following criteria are met: the component is a business, discrete financial information is available, and segment management
regularly reviews the operating results of that component. Segment management will generally consist of different people than the chief operating decision maker. Additional guidance on components may be found in EITF Topic D-101, *Clarification of Reporting Unit Guidance in Paragraph 30 of FASB Statement No. 142*, including guidance on whether components may be aggregated.

While the components of an operating segment may be aggregated for the purposes of goodwill impairment testing and considered a single reporting unit if the components have similar economic characteristics, it is not permissible to aggregate separate operating segments into one reporting unit. At a minimum, each operating segment is a reporting unit under SFAS 142 that should be tested separately. Additionally, registrants should not aggregate components from different operating segments that share similar economic characteristics into a single reporting unit.

Given the impact the identification of reporting units can have on the determination of a goodwill impairment charge, registrants should consider providing disclosure in the critical accounting estimates section of MD&A. This disclosure may be particularly important when the amount of goodwill is material. The disclosure should address how the reporting units were identified, how goodwill is allocated to the reporting units, and whether there have been any changes to the number of reporting units, or the manner in which goodwill was allocated. If such changes have taken place, they should be explained.

**M. Issues Associated With SFAS 133, Accounting for Derivative Instruments and Hedging Activities**

1. **Formal Documentation Under SFAS 133**

SFAS 133 contains explicit guidance regarding the application of hedge accounting models, including documentation and effectiveness assessment requirements. One of the fundamental requirements of SFAS 133 is that *formal* documentation be prepared at inception of a hedging relationship. The standard stresses the need for the documentation to be prepared contemporaneously with the designation of the hedging relationship. The formal documentation must identify the following:

- the entity’s risk management objectives and strategies for undertaking the hedge,
- the nature of the hedged risk,
- the derivative hedging instrument,
- the hedged item or forecasted transaction,
- the method the entity will use to retrospectively and prospectively assess the hedging instrument’s effectiveness, and
- the method the entity will use to measure hedge ineffectiveness (including those situations in which the change in fair value method as described in SFAS 133 Implementation Issue No. G7 will be used); see EITF D-102.
Contemporaneous designation and documentation of a hedging relationship are fundamental to the application of hedge accounting. If contemporaneous documentation can not be demonstrated, an auditor will be unable to determine whether the company has, after the fact, selected the hedged item or transaction, or the method of measuring effectiveness, to achieve a desired accounting result. Upon the adoption of SFAS 133, the staff believes that most registrants undertook efforts to adhere to the spirit and form of the standard and to satisfy all of its requirements. In the course of the filing review process, however, the staff has encountered instances where registrants have not been diligent in meeting those requirements. The staff has noted instances of shortcutting or minimizing the process, as well as instances of aggressive interpretation and attempts to achieve results inconsistent with the spirit of SFAS 133. The staff will continue to challenge the application of hedge accounting in instances where an entity has not contemporaneously complied with SFAS 133’s formal documentation requirements upon designation of a hedging relationship, or has otherwise shortcutted or circumvented the process. Two documentation requirements are emphasized below.

**The hedged forecasted transaction**

SFAS 133 stresses that the documentation of the hedged forecasted transaction must be sufficiently specific such that when a transaction occurs, it is clear whether or not that particular transaction is the hedged transaction. Thus, the documentation of the forecasted transaction should include reference to the timing (i.e., the estimated date), the nature, and amount (i.e. the hedged quantity or amount) of the forecasted transaction.

**Description of how the entity will assess and measure hedge effectiveness**

While SFAS 133 provides an entity with flexibility in determining the method for assessing hedge effectiveness, the methodology used must be reasonable, and must be documented at inception of the hedging relationship. Additionally, SFAS 133 requires that an entity use the chosen method consistently throughout the hedge period (a) to assess, at inception of the hedge and on an on-going basis, whether it expects the hedging relationship to be highly effective in achieving offset and (b) to determine the ineffective aspect of the hedge. The method used for assessing hedge effectiveness and measuring ineffectiveness must be documented with sufficient specificity so that a third party could perform the measurement based on the documentation and arrive at the same result as the registrant. When hedge accounting has a material impact on a registrant, we encourage registrants to include disclosures that clearly describe the specific methodology used to test hedge effectiveness for each type of SFAS 133 hedge, as well as how often those tests are performed. Disclosures of this type may be appropriately included within the critical accounting estimates section of MD&A.

2. **Shortcut method of assessing hedge effectiveness (New)**

One of the general requirements of SFAS 133 is that hedge accounting is only appropriate for hedging relationships that an entity expects to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the risk being hedged. To meet this requirement, companies must assess the effectiveness of a hedging relationship as described in the preceding bullet.
The shortcut method is an exception from the periodic assessment and measurement requirements of SFAS 133 and the circumstances in which it can be applied are limited. SFAS 133 limits its use to hedges of interest rate risk that involve interest-rate swaps and recognized interest-bearing assets or liabilities, hedges that are often referred to as “straightforward hedges of interest rate risk”. It also requires that general hedge requirements such as contemporaneous formal documentation be met. It then adds additional criteria in paragraph 68 specifically for shortcut method hedges to be met.

The staff has seen several instances in which the shortcut method has been inappropriately applied. Many of the hedges encountered did appear to provide economic offset, however, they failed to meet one or more of the criteria necessary to qualify for the shortcut method. In some instances registrants assumed that they did not need to assess or measure ineffectiveness because they had met the "spirit" of the shortcut method. The staff does not believe that the shortcut criteria have a "spirit" or a principle that can be met without strictly complying with the stated requirements. This view is consistent with SFAS 133 Implementation Issue No. E4 which indicates that each and every one of the shortcut criteria must be met and that "a hedging relationship cannot qualify for application of the shortcut method based on an assumption of no ineffectiveness justified by applying other criteria.”

One example of where the shortcut method has been inappropriately applied involves the requirement that interest rate swaps must have a fair value of zero at the inception of the hedging relationship. In some situations, registrants have incorporated a financing element in the interest rate swap that results in a fair value other than zero. The financing element is included as an adjustment to the "pay" or "receive” legs of the interest rate swap. These adjustments are often made in lieu of paying or receiving a dealer or broker fee or some other component of the transaction that was being exchanged. These hedging transactions involve multiple components and, since the financing element causes the swap to have a fair value other than zero at inception (even if no cash is exchanged at inception), the hedge does not qualify for the shortcut method.

3. Financial Statement Presentation and Disclosure (Updated)

Registrants generally have continued the historical practice of including the results of hedging relationships on a net basis in the income statement line item associated with the hedged item. There is no required classification for the gain or loss recognized for hedge ineffectiveness or for any component of a derivative instrument’s gain or loss that is excluded from the assessment of hedge effectiveness, but the amount of this net gain or loss and its income statement classification must be disclosed. Consistent classification should be observed in each period. Derivative assets and liabilities may be offset only to the extent permitted by FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts. Although bifurcated for measurement purposes, embedded derivatives should be presented on a combined basis with the host contract, except in circumstances where the embedded derivative is a liability and the host contract is equity.

There is similarly no guidance in SFAS 133 related to classification of derivatives that do not qualify for hedge accounting. As a result, we encourage disclosure of the location in the
income statement where the changes in the fair value of non-hedge accounting derivatives are reflected as well as the amount. However, we generally believe that a presentation that splits the components of a derivative into different line items on the income statement or that reclassifies realized gains and losses of a derivative out of the line item that included unrealized gains and losses of the same derivative is inappropriate. For example, if a registrant classifies changes in fair value of economic hedges (unrealized gains and losses) in a single line item such as “risk management activities”, a registrant should not reclassify realized gains and losses (the periodic or final cash settlements from these economic hedges) in the period realized out of risk management activities and into revenue or expense lines associated with the related exposure. While SFAS 133 was essentially “silent on geography,” it was the clear intention of the FASB to eliminate the practice of synthetic instrument accounting. The presentation described in the above example is essentially a form of synthetic instrument accounting from an income statement perspective.

Registrants should focus on the clarity of their disclosures when they use hedges, both those that qualify for hedge accounting under SFAS 133 and those that don’t. Registrants should provide transparent, “plain English” disclosures related to derivatives, including reasons for their use, associated hedging strategies, and methods and assumptions used to estimate fair value, as required by SFAS 107 and SFAS 133, and Item 305 of Regulation S-K. Furthermore, when hedge accounting has a material impact on the registrant, registrants should ensure they have disclosures, for each type of fair value and cash flow hedge, that clearly describe the specific type of asset or liability (or identified portion thereof) being hedged and the derivative used for that type of hedge. Registrants should also consider providing disclosures regarding their use of SFAS 133 elections. We note that the FASB staff recently proposed adding a project to the FASB's agenda to increase the disclosure requirements of SFAS 133. The proposed project would consider existing disclosures and assess new requirements that would improve transparency and relevance to the financial statement readers. We encourage registrants to monitor the FASB’s discussions in this area.

4. Auditing Fair Values and SFAS 133

Management’s assertions regarding fair values, timely hedge designation and documentation, and hedging effectiveness should be subject to on-going audit testing. Auditors should refer to SAS 92, SAS 73, SAS 70, and 37, as adopted by the PCAOB in Rule 3200T, as well as Independence Standards Board Interpretation 99-1, as adopted by the PCAOB in Rule 3600T, for guidance in this area. In addition, the AICPA has issued an Audit Guide, Auditing Derivative Instruments, Hedging Activities and Investment Securities.

N. Disclosure of Off-Balance Sheet Arrangements (New)

Item 303 of Regulation S-K requires registrants to provide within MD&A a separately-captioned section that discusses off-balance sheet arrangements. Registrants are only required to discuss off-balance sheet arrangements when those arrangements have or are reasonably likely to have a material current or future effect on the registrant’s financial condition, changes in
financial condition, revenues and expenses, results of operations, liquidity, capital expenditures, or capital resources. This disclosure threshold is in line with the rest of MD&A.

Staff reviews have discovered that registrants often provide the disclosure required by Item 303 throughout MD&A and the footnotes to the financial statements. The rules require a separate off-balance sheet section to highlight for investors in one place all of the types of arrangements that meet the definition of an off-balance sheet arrangement. In addition, the disclosure provided is often boiler-plate.

In preparing MD&A, registrants should consider whether the descriptions of off-balance sheet arrangements are presented in one section that is clearly labeled and that the relevant disclosure is presented there. The nature and business purpose (i.e. why the transaction was structured as off-balance sheet) of off-balance sheet arrangements, as well as the exposure to risk that results from the arrangements should be discussed. To increase transparency for investors, registrants should also consider disclosing that they have no material off-balance sheet arrangements, if that is the case.

In order to assist registrants to identify their business activities that may have off-balance sheet implications, Item 303 explicitly defines the off-balance sheet arrangements that are required to be disclosed. The definition focuses on the common types of structures that may result in a registrant obtaining or retaining risk of loss that is not transparent to investors. The definition of off-balance sheet arrangements employs concepts in accounting literature in order to define the categories of arrangements with precision. Generally, the definition includes the following categories of contractual arrangements:

- certain guarantee contracts,
- retained or contingent interests in assets transferred to an unconsolidated entity,
- derivative instruments that are classified as equity, or
- material variable interests in unconsolidated entities that conduct certain activities.

The first two types of arrangements are fairly straightforward. The first refers to guarantee contracts that meet the recognition and measurement provisions in FASB Interpretation No. 45. The second refers to an arrangement in which an asset is sold to an off-balance sheet entity, but the seller retains an interest in the sold asset that provides support to the off-balance sheet entity.

The third type of arrangement refers to certain derivative instruments. The derivative instruments referred to meet the definition of a derivative, but because they are indexed to the company’s stock and classified in stockholders’ equity, qualify for the paragraph 11 a. of Statement 133 scope exception. They are considered “off-balance sheet” because they are not classified as liabilities and changes in their fair value are not recognized in income.

While it is not uncommon for registrants to enter into share based contracts that are not accounted for as derivatives because of the paragraph 11 a. scope exception, the staff has noted limited discussion of equity-linked derivatives in the off-balance sheet arrangement section.
Registrants often disclose a variety of equity-linked contracts, such as convertible debt arrangements, stock warrants and forward agreements to sell shares at pre-set terms, where the registrant has applied the paragraph 11 a. scope exception, yet the arrangements are not fully disclosed in the off-balance sheet arrangement section of MD&A. To ensure completeness of the information provided in the off-balance sheet arrangement section, registrants should carefully consider whether there are any outstanding contracts indexed to their own stock and classified as stockholders’ equity that are reasonably likely to materially impact the registrant’s financial condition, liquidity or capital resources.

A simple example of an equity-linked contract that would likely need to be described in the off-balance sheet arrangement section of MD&A is outstanding convertible debt that is reasonably likely to be converted and could result in significant dilution that would be reasonably likely to limit the ability of the registrant to raise additional capital. A more complex example that illustrates the need for disclosure in the off-balance sheet section of MD&A is an accelerated share repurchase program (ASR). A typical ASR involves the combination of a buyback of common stock from an investment bank, which typically borrows the shares from investors, and a forward contract with the investment bank on the company’s common stock with settlement of the forward contract indexed to the company’s common stock. Although an ASR is intended primarily to boost earnings per share for stock still outstanding, the ASR subjects the registrant to the risk of significant additional payments resulting from an increase in the share price of the registrant’s common stock and therefore needs to be discussed in the off-balance sheet section of MD&A if reasonably likely to have a material effect.

The fourth type of arrangement could encompass a variety of fact patterns. This type of arrangement refers to situations in which a registrant holds a material variable interest in an unconsolidated entity that provides financing, liquidity, market risk or credit support to the registrant or engages in leasing, hedging or research and development services with the registrant. In this context a variable interest refers to an investment in an unconsolidated entity that would meet the FIN 46 definition of a variable interest, because the investment absorbs expected losses and residual returns that occur in the unconsolidated entity, but the entity in which the interest is held does not need to meet the FIN 46 definition of a variable interest entity.

For additional information, see the Commission staff report prepared by the Office of the Chief Accountant, the Office of Economic Analysis and the Division of Corporation Finance on off-balance sheet arrangements, special purpose entities and related issues, released on June 15, 2005 (see the full text of the staff study at www.sec.gov/news/studies/soxoffbalancerpt.pdf ).

**O. Market Risk Disclosures**

Item 305 of Regulation S-K prescribes disclosures about derivatives and market risks inherent in derivatives and other financial instruments. Registrants should clearly explain how they manage their primary market risk exposures, including describing the objectives, general strategies and instruments used to manage each exposure. In the discussion of how the registrant manages risk exposure, registrants should separately discuss business decisions that result in natural (or economic) hedges and decisions to use derivative instrument positions to hedge
exposures. Changes in the strategies or tools used to manage exposures during the year in comparison to the prior year should be clearly disclosed, as well as any known or expected changes in the future. Registrants should be specific in explanations of the intended result of the application of these policies (e.g., percentage of production intended to be hedged) and furnish any other information that would assist investors in understanding your particular position. To assure balance and usefulness, disclosures about commodity derivatives should be related to the registrant’s exposures in the underlying commodity.

**P. Allowance for Loan Losses**

1. **Disclosure**

The determination of the allowance for loan losses requires significant judgment. The balance in the allowance for loan losses should reflect management’s best estimate of probable loan losses related to specifically identified loans as well as probable incurred loan losses in the remaining loan portfolio. SFAS 5 and FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, limit loss allowances to losses that have been incurred as of the balance sheet date. Accordingly, allowances for loan losses should be based on past events and current economic conditions. Disclosures that explain the allowance in terms of potential, possible, or future losses, rather than probable losses, suggest a lack of compliance with GAAP and are not appropriate.

Accounting Principles Board Opinion No. 22, *Disclosure of Accounting Policies*, sets forth the general requirements for accounting policy disclosures in the financial statements. Industry Guide 3 specifies additional detail that should be provided in explanation of loss allowances within the Description of Business. Viewed together, these disclosures should describe in a comprehensive and clear manner the registrant’s accounting policies for determining the amount of the allowance in a level of detail sufficient to explain and describe the systematic analysis and procedural discipline applied. Registrants commonly develop different elements in their allowances to estimate (1) losses based upon specific evaluations of known loss on individual loans, (2) estimated unidentified losses on various pools of loans and/or groups of graded loans, and (3) other elements of estimated probable losses based on other facts and circumstances. The disclosures should describe and quantify each element of the allowance, and explain briefly how the registrant’s procedural discipline was applied in determining the amount, and not simply the “adequacy,” of each specific element. If loans are grouped by pool or by grading within type to estimate unidentified probable losses, the basis for those groupings and the methods for determining loss factors to be applied to those groupings should be described. The basis for estimating the impact of environmental factors, such as local and national economic conditions and trends in delinquencies and losses, whether through modifying loss factors or through a separate allowance element, should be disclosed. Changes in methodology and their impact should be disclosed in accordance with Accounting Principles Board Opinion No. 20, *Accounting Changes*. 
MD&A should explain the period-to-period changes in specific elements of the allowance. It also should discuss the extent to which actual experience has differed from original estimates. The reasons for changes in management’s estimates should indicate what evidence management relied upon to determine that the revised estimates were more appropriate and how those revised estimates were determined. A registrant following a procedural discipline should be recording provisions for loan losses that reflect the changes in asset quality as measured in the registrant’s periodic loan reviews. MD&A should discuss the reasons for the changes in assets quality and explain how those changes have affected the allowance and provision. If historical loss experience appears low or high relative to the level of the allowance at the latest balance sheet date, a reconciling explanation should be provided. If a registrant changes its methodology, the basis for changing its methodology and the effects of the change should be explained.

2. Financial statement presentation

Allowances for credit losses are valuation accounts that should be presented as a reduction of the carrying value of the related balance sheet item. The allowance for loan losses should not include amounts provided for losses on financial instruments that are not classified on the balance sheet as loans. FASB Interpretation No. 45, Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, issued in November 2002, requires that most guarantees be recognized and initially measured at fair value in the financial statements. The liability for guarantees should be classified separately from the allowance for loan losses.

As noted in Section II.M.2., SFAS 133 does not provide specific guidance on geography, but at the same time the staff believes that some classifications may not make sense. As an example, a financial institution classifying in the provision for loan losses all changes in credit derivatives used as economic hedges would not seem appropriate given the importance of that line item to certain credit quality analyses.

Financial institutions must present the provision for loan losses as a deduction in the determination of net interest income, pursuant to Article 9 of Regulation S-X. Credit loss provisions on other types of balance sheet and off-balance sheet items that do not affect net interest income should not be included in the provision for loan losses. Loss provisions not related to interest income should be recorded in other appropriate categories of income or expense. Direct transfers of amounts between the allowance for loan losses and other credit loss allowances are not appropriate, except for a circumstance in which an off-balance sheet loan commitment becomes an outstanding loan. Changes in the amount of the allowance for loan losses should be reflected in the provision for loan losses, while changes in other allowances should be reflected in other appropriate categories of income or expense.

Q. Loans and Other Receivables
1. **Accounting for Loans or Other Receivables Covered by Buyback Provisions**

The terms of sale of loans or other receivables, including, but not limited to, those securitized through the Government National Mortgage Association or another GSE, may either require or allow for the transferor’s repurchase of such loans or receivables upon an event of default.

Paragraph 55 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, a replacement of FASB Statement No. 125, specifies the accounting in a circumstance where the seller regains control of assets previously accounted for appropriately as having been sold, such as in the case of a call option that becomes exercisable upon the event of borrower default. The assets should be accounted for in the same manner as a purchase of the assets from the former transferee in exchange for liabilities assumed. Specifically, the transferor recognizes in its financial statements those assets together with liabilities to the former transferees or beneficial interest holders in those assets at fair value on the date that the call becomes exercisable, regardless of whether it intends to exercise the call. EITF Issue 02-9 further clarifies the accounting for a transferor’s re-recognition of assets pursuant to paragraph 55 of SFAS 140.

The original balance sheet classification of the asset when originally transferred should be maintained when control over that asset is re-recognized by the transferor. For instance, if the asset subject to the call or repurchased by the transferor is a loan, the balance sheet classification by the transferor upon re-recognition should be Loans, not Other Assets. No loan loss allowance should be recorded upon initial re-recognition of loans at fair value. Subsequent accounting for the re-recognized loan will depend on whether the loans are classified as held for investment or held for sale.

In the event that loans re-recognized by the transferor have the risk elements contemplated by Item III.C.1.of Industry Guide 3 (i.e., nonaccrual, past due, restructured), the amount of such loans should be included in the disclosures required by that Item. Supplemental disclosures may be made to facilitate understanding of the aggregate amounts reported pursuant to Item III.C.1. These disclosures may include, for example, information as to the nature of the loans, any guarantees, the extent of collateral, or amounts in process of collection. For example, if a loan re-recognized by a transferor is accruing, but it is contractually past due 90 days or more as to principal or interest, that loan should be included in the disclosure required by Item III.C.1(b) even if the loan is guaranteed through a government program, such as the Veterans Administration (VA) or Federal Housing Authority (FHA).

2. **Disclosures About Restructured Loans and Other Receivables**

Paragraph 40 of FASB Statement No. 15, *Accounting by Creditors for Troubled Debt Restructurings*, as amended by SFAS 114, requires disclosure about restructured loans, including information about restructured loans included in large groups of smaller-balance homogeneous loans such as credit cards, residential mortgages, and consumer installment loans. Paragraph 5
of SFAS 114 states, “[t]his Statement also addresses the accounting by creditors for all loans that are restructured in a troubled debt restructuring involving a modification of terms of a receivable, except loans that are excluded from the scope of this Statement in paragraphs 6(b)-(d), including those involving a receipt of assets in partial satisfaction of a receivable.” Large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment are not among those exclusions. Accordingly, in the event that a loan is restructured, all of the provisions of SFAS 114 apply, including the disclosure provisions set forth in paragraph 20 of that Statement, as amended by FASB Statement No. 118, Accounting by Creditors for Impairment of a Loan – Income Recognition and Disclosures, an amendment of FASB Statement No. 114.

Disclosures about certain restructured loans also are required for certain registrants by Item III.C.1(c) of Industry Guide 3.

3. Potential Problem Loans

We remind registrants subject to the provisions of Industry Guide 3 that Instruction 2 to Item III.C. requires disclosures about loans which are not now disclosed as past due but where known information about possible credit problems of borrowers causes management to have serious doubts as to the ability of such borrowers to comply with the present loan repayment terms and which may result in their being included later in past due loans.

4. Loans Held for Sale

AICPA Statement of Position 01-6, Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others (“SOP 01-6”) has a scope that includes all entities that lend to or finance the activities of others, including financing arrangements that only involve extending credit to trade customers resulting in trade receivables. Paragraph 8 of SOP 01-6 states that loans and trade receivables should only be classified as held for investment when management has the intent and ability to hold that loan/receivable for the foreseeable future or until maturity or payoff. Loans/receivables not held for investment should be accounted for as held for sale and reported at the lower of cost or fair value. If a registrant decides to sell loans/receivables not previously classified as held for sale, such loans/receivables should be transferred to the held for sale classification and reported at lower of cost or fair value. Continuing to report these loans/receivables on an adjusted cost basis is inappropriate because it may delay recognition of losses due to declines in fair value.

Registrants should appropriately identify and account for loans and receivables that the registrant intends to sell, and consider the need for clarifying disclosure that:

- Identifies the amount of loans/receivables held for sale;
- Explains how it determines which loans/receivables are initially accounted for as held for sale or are later transferred to the held for sale classification;
- Describes the method it uses to determine the lower of cost or fair value for loans/receivables held for sale; and
Reconciles the changes in loans/receivables held for sale balances to the amounts presented in the consolidated statement of cash flows.

Registrants should ensure that they have appropriately classified the cash payments and receipts on loans that are held for sale in the statement of cash flows (loans that are unrelated to the sale of inventory; see Section II.C.1. above). Paragraph 9 of SFAS 102 states that cash flows related to loans that were originated or purchased specifically for resale and are held for short periods of time should be classified as operating. Cash flows related to loans that were not acquired specifically for resale and carried at the lower of cost or market value should be classified as investing.

5. Disclosures about Residential Loan Products

In recent years lending institutions have increased originations of mortgage loans that include features that increase the credit risk of the loan for the lender. These residential mortgage loans have features that may allow the borrower:

- To borrow more than 80% of the appraised value of the home (sometimes up to a 125% loan-to-value ratio), often without buying private mortgage insurance;
- To pay a monthly mortgage payment that is less than the interest expense incurred on the loan, which results in the principal balance of the loan increasing over time (negative amortization); and/or
- To qualify for the loan based on the borrower’s ability to pay a minimum payment, even though the borrower will be required to pay significantly higher monthly payments in future periods unless the mortgage is prepaid.

One such product is an option adjustable-rate mortgage (option ARM), which is being sold to home buyers who desire smaller monthly mortgage payments. This mortgage product gives borrowers the option to make monthly payments that are less than the interest actually owed on the loan. The result is that the deferred interest is added to the principal amount of the mortgage loan creating a rising loan balance, often referred to as a negative amortization loan. If the loan balance grows to the extent that the loan-to-value ratio exceeds an established threshold, the lender may restructure the loan, requiring the borrower to immediately begin making larger payments.

The types of residential mortgage loans held and the underwriting standards used to originate these loans are important to an understanding of a registrant’s financial condition and results of operations. While the information required by Industry Guide 3 includes basic categorical statistics about a registrant’s loan portfolio, more detailed information about certain loan products may be needed in order to provide a complete picture of the portfolio’s credit risk. Some disclosure examples follow for use in Description of Business or MD&A, as appropriate.

Provide disaggregated information about residential mortgage loans with features that may result in higher credit risk
• Describe the significant terms of each type of residential mortgage loan product offered, including underwriting standards used for each product, maximum loan-to-value ratios and how credit management monitors and analyzes key features, such as loan-to-value ratios and negative amortization, and changes from period to period.

• Disclose the approximate amount (or percentage) of loans originated during the period and loans as of the end of the reporting period that relate to each type of residential mortgage loan product.

• Disclose the approximate amount (or percentage) of off-balance sheet loans with retained credit risk which relate to each type of residential mortgage loan product.

• Disclose the amount of loans that experienced negative amortization during the period and the amount of increase in the loan balance during the period that resulted from negative amortization.

• Describe your policy for placing loans on non-accrual status when the loan’s terms allow for a minimum monthly payment less than interest accrued on the loan, and the impact of this policy on the nonperforming loan statistics disclosed.

• Disclose the approximate amount (or percentage) of residential mortgage loans as of the end of the reporting period with loan-to-value ratios above 100%.

• Disclose any geographic concentrations that exist as of period end in your portfolio of residential mortgage loans with high loan-to-value ratios.

Describe risk mitigation activities used to reduce exposure to credit risk related to residential mortgage loans

• Describe risk mitigation transactions used to reduce credit risk exposure, such as insurance arrangements, credit default agreements or credit derivatives.

• Explain any limitations of your credit risk mitigation strategies.

• Disclose the impact that credit risk mitigation transactions have had on your financial statements.

Disclose trends related to residential mortgage loans with features that may result in higher credit risk that are reasonably likely to have a material favorable or unfavorable impact on net interest income after the provision for loan loss

• Disclose any changes in the percentage of borrowers who have chosen a minimum payment option during the period instead of choosing a payment option that includes full payment of interest expense or payment of interest and principal.

• Describe any significant weakening in local housing markets in which you have a concentration of residential mortgage loans with high loan-to-value ratios.

• Disclose changes in credit losses and interest income recognized for higher risk loans.
R. Disclosure of Liability for Unpaid Claims and Claim Adjustment Expenses and Reinsurance Recoverables on Paid and Unpaid Claims (New)

Property-casualty insurance enterprises must estimate their liability for unpaid claims and claim adjustment expenses at each reporting date. Currently, U.S. GAAP and SEC rules and related interpretations, primarily FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, AICPA Statement of Position No. 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises*, Industry Guide 6, “Disclosures Concerning Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Insurance Underwriters”, and MD&A, require disclosure intended to help a reader understand the complexity, judgment, and uncertainty inherent in this estimate. The disclosure should enable a reader to understand:

- management’s method for establishing the estimate for each material line of business and how the methodology is appropriate for the reporting, development, and payment patterns inherent in the business line;
- any changes to significant assumptions used to determine the current period estimate from the assumptions used in the immediately preceding period, the reason for the change, and the impact of the change; and
- the reasonably likely variability inherent in the current estimate and the impact that variability may have on future reported results, financial condition and liquidity.

Disclosure about the liability for unpaid claims and claim adjustment expenses should identify underlying causes, not just intermediate effects, and should include a quantitative as well as qualitative discussion. Disclosure should be concise and to the point and should avoid unnecessary repetition. Some particular suggestions follow.

**Management’s methodology for estimating the liability for unpaid claims and claim adjustment**

SFAS 60 and SOP 94-5 require disclosure of the policies and methodologies for estimating the liability for unpaid claims and claim adjustment expenses. This disclosure should:

- Describe management’s policies and methodologies for each material line of business.
- Identify and describe the actuarial method used. This description should:
  - Explain how the method appropriately considers the risks of each material line of business and the time period that claims are both reported and ultimately settled.
  - Describe the method used to calculate the liability for incurred but not reported claims.
- Describe management’s policy, if any, for adjusting the liability for unpaid claims and claim adjustment expenses to an amount that is different than the amount determined by its actuaries.
o If such a policy exists, describe the method used by management to determine the adjustment and the extent to which it relies on objective versus subjective determinations. Such adjustments may include, but not be limited to, an incremental provision, a reduction in the liability, or a reversal of a previously recorded adjustment.

o When such adjustments or reversals are made, include MD&A disclosure that identifies the amount of the adjustment or reversal and the underlying reasons for the adjustment or reversal.

• Describe any differences in the annual and interim procedures for determining the liability for unpaid claims and claim adjustment expenses.

**Changes in the provision for insured events of prior years**

SOP 94-5 and MD&A require disclosure of the reasons for incurred claims and claim adjustment expenses recognized in the current year’s income statement attributable to insured events of prior fiscal years. This disclosure should:

• Quantify the amount of the change attributable by line of business and by accident year within the line.
• Identify and describe in reasonable detail the nature and extent of new events that occurred or additional experience/information obtained since the last reporting date that led to each material change in estimate.
• Explain why recognition occurred in the periods that it did and why recognition in earlier periods was not required.

**Changes in significant assumptions**

Industry Guide 6 and MD&A require disclosure about reserving assumptions and recent changes therein. For each material line of business:

• Identify and describe the key assumptions that materially affected the current estimate of the liability for unpaid claims and claim adjustment expense.
• For each of the key assumptions, quantify and explain a material change from the assumption used in the immediately preceding period. The discussion should focus on actual changes in assumptions and not hypothetical possibilities.
• Identify and discuss key assumptions as of the latest balance sheet date that are premised on future loss reserve development patterns that are inconsistent with historical patterns and explain why these assumptions are appropriate.

**Reinsurance**

Industry Guide 6 and MD&A also require disclosure about reinsurance transactions that have a material effect on earnings or reserves. This disclosure should:

• Discuss and quantify the effect that ceded reinsurance activities had on financial position, results of operations, and cash flows for the periods presented.

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Describe changes to reinsurance strategies and any limitations on the registrant’s ability to cede future losses on a basis consistent with historical results, and the effects those changes and limitations are expected to have on financial position, operating results and cash flows. Such changes and limitations could relate to changes in reinsurance market conditions, a restructuring of reinsurance treaties or the absence of remaining limits for specific accident years under existing treaties.

Reasonably likely variability in liability at most recent reporting date

MD&A should analyze whether the recognized liability for claims and claim adjustment expense is reasonably likely to change in the future. For each material line of business:

- Identify the key assumptions that are reasonably likely to change.
- Explain why management believes each change is reasonably likely.
- Provide an analysis (rather than merely disclosing the effect of an arbitrary selected percentage change in the liability) preferably in tabular format, that quantifies the effect that the reasonably likely changes in key assumptions may have on future financial position, liquidity and results of operations.

S. Materiality Assessments and the Use of Sampling

Before a registrant decides to not apply specific requirements of GAAP because of materiality, the registrant and its auditors have an obligation to appropriately evaluate whether the impact of not applying that required guidance is material, as discussed in SAB Topic 1. M. That evaluation should be documented and completed for each reported financial period. The registrant’s methodology for determining the quantitative impact of not applying the required guidance must allow the registrant and its auditor to reliably measure the difference for each reported financial period. If the pool of transactions to which the relevant accounting guidance has not been applied is not homogenous or varies from period to period, a sampling technique will most likely not allow the registrant and its auditor to reliably measure the impact of not applying GAAP.

T. Independent Registered Auditors

1. Change of Accountants – Merger of Firms

A merger of accounting firms always results in a change in accountants due to the change in legal entity of the firm that performs the audit. The merger could take the form of a legal merger of 2 firms, an asset purchase, or the admission of a new partner(s) from another firm who brings SEC clients to the admitting firm. The acquired firm may or may not separately continue in business, except in a legal merger where the acquired firm would not practice separately.
An Item 4.01 Form 8-K must be filed no later than 4 business days after the merger. In addition to disclosing the name of the new accounting firm, the Form 8-K disclosure should describe the merger and state whether the merged firm resigned as auditors or the registrant dismissed the old firm. Auditors and registrants should be aware of any independence issues that could arise from the merger and address them appropriately.

If the old firm continues in business, even if as a shell, and is licensed to practice and in good standing as a public accounting firm, it would be able to continue to reissue prior opinions or provide consents to the use of prior opinions. Should the new firm be willing to assume liability for the old firm’s audits, it could issue a new opinion that covers the prior audited periods and provide consents to the use of that opinion.

If neither firm is willing or able to reissue opinions on prior audited periods or provide a consent to the use of a prior opinion, the registrant would have to provide a formal request for waiver of consent under Securities Act Rule 437C or write to the staff of the Office of the Chief Accountant in the Division of Corporation Finance to request a waiver of the re-issuance of a prior opinion where no consent is needed. Generally, the staff limits granting waivers to hostile takeovers/tender offers.

2. PCAOB Registration

PCAOB Rule 2100 requires registration with the PCAOB of any firm that 1) prepares or issues an audit report with respect to a registrant or 2) plays a substantial role in the preparation or furnishing of an audit report with respect to a registrant. The deadline for registration was October 22, 2003 (or, for foreign public accounting firms, July 19, 2004). An unregistered firm cannot issue a new opinion (even if dated before October 22) or update/dual-date its opinion after October 22, 2003 on an issuer’s financial statements.

A firm does not have to be registered to reissue a prior report (or issue a consent to the use of a prior report) issued before October 22, 2003, or to issue a report or consent on financial statements of a material acquiree that is a private company (non-issuer) that are filed pursuant to Rule 3-05 of Regulation S-X or Rule 310(c) of Regulation S-B.

An unregistered firm may be able to perform some audit services if the services represent less than 20% of the total engagement hours or fees provided by the principal accountant related to issuing all or part of its audit report. See PCAOB Rules 1001 and 2100 for more details.

3. Pre-Approval of Audits of Employee Benefit Plans

An employee benefit plan may be an affiliate of a registrant as its plan sponsor. The Commission's independence rules related to pre-approval surround services provided to the issuer and the issuer's subsidiaries, but not services provided to other affiliates of the issuer that are not subsidiaries. Therefore, the independence rules do not require the audit committee of the plan sponsor to pre-approve audits of the employee benefit plans, although the audit committee
is encouraged to do so. When employee benefit plans are required to file Form 11-K, those plans are separate issuers under the Exchange Act; as a result, those issuers are subject to the pre-approval requirements. This pre-approval can be provided by either the audit committee of the plan sponsor or the appropriate entity overseeing the activities of the employee benefit plan, such as the trustee, plan administrator or responsible party.

The Commission's rules require that all fees, including fees related to audits of employee benefit plans, paid to the principal auditor be included in the company’s fee disclosures, regardless of whether or not the audit committee of the company pre-approved those fees. As part of the exercise to gather the information for the required fee disclosures, the audit committee should be made aware of all fees paid to the principal auditor, including those related to audits of the employee benefit plans. The company may elect to separately indicate in their disclosures those fees paid to the principal auditor that were not subject to the pre-approval requirements.

Registrants and their auditors are reminded that the financial statements included in a Form 11-K must be audited by an independent auditor that is registered with the PCAOB and the audit report must refer to the standards of the PCAOB rather than GAAS.

III. Other Information About the Division of Corporation Finance and Other Commission Offices and Divisions

A. Other Sources of Information

Much information about the Commission, proposed and recently adopted rules, and other activities and developments may be found at the Commission’s website - http://www.sec.gov. Information about current issues and interpretations in the Division of Corporation Finance can be found at www.sec.gov/divisions/corpfin.shtml. Information of particular interest to accountants practicing before the Commission is at http://www.sec.gov/about/offices/oca.htm. Other documents that may be of particular interest to readers of this outline include:


B. Corporation Finance Staffing and Phone Numbers (Updated)

The Division’s organizational structure follows:

Division Director – John White (202) 551-3100
Deputy Director – Martin P. Dunn (202) 551-3120
Deputy Director – Shelley Parratt (202) 551-3130
Operations

Associate Director (Disclosure Operations) – Paul Belvin (202) 551-3150
Associate Director (Disclosure Operations) – James Daly (202) 551-3140
Associate Director (Disclosure Operations) – Barry Summer (202) 551-3160
Senior Special Counsel (Disclosure Operations) – James Budge (202) 551-3115

Disclosure Support and Other Offices

Associate Director (Legal) – Paula Dubberly (202) 551-3180
Associate Director (Regulatory Policy) – Mauri Osheroff (202) 551-3190
Senior Counsel to the Director – Amy Starr (202) 551-3115
Senior Counsel to the Director – Lillian Brown (202) 551-3115
Senior Special Counsel (Regulatory Policy) – Mark Green (202) 551-3195
Office of Chief Counsel – David Lynn, Chief (202) 551-3520
Office of Mergers and Acquisitions – Brian Breheny, Chief (202) 551-3440
Office of International Corporate Finance – Paul Dudek, Chief (202) 551-3450
Office of Rulemaking – Elizabeth Murphy, Chief (202) 551-3430
Office of Small Business Policy – Gerald Laporte, Chief (202) 551-3460
Office of Enforcement Liaison – Mary Kosterlitz, Chief (202) 551-3420
Office of Global Security Risk – Cecilia Blye, Chief (202) 551-3470
Office of EDGAR and Information Analysis – Herbert Scholl, Chief (202) 551-3610

Office of the Chief Accountant [fax - (202) 772-9213]

Associate Director (Chief Accountant) – Carol Stacey (202) 551-3405

Craig Olinger, Deputy Chief Accountant (202) 551-3400
  Liaison to: Foreign Private Issuers
Louise Dorsey, Associate Chief Accountant (202) 551-3400
  Liaison to: Office # 5 (Structured Finance, Transportation and Leisure)
  Office # 8 (Real Estate and Business Services)
Todd Hardiman, Associate Chief Accountant (202) 551-3400
  Liaison to: Office # 1 (Health Care and Insurance)
  Office # 10 (Electronics and Machinery)
Stephanie Hunsaker, Associate Chief Accountant (202) 551-3400
  Liaison to: Office # 7 (Financial Services)
Steven Jacobs, Associate Chief Accountant (202) 551-3400
Joel Levine, Associate Chief Accountant (202) 551-3400
  Liaison to: Office # 2 (Consumer Products)
  Office # 3 (Computers and On Line Services)
Leslie Overton, Associate Chief Accountant (202) 551-3400
  Liaison to: Office # 4 (Natural Resources and Food)
  Office # 6 (Manufacturing and Construction)
Sondra Stokes, Associate Chief Accountant (202) 551-3400
  Liaison to: Office # 9 (Emerging Growth Companies)
Assistant Directors (AD), Senior Assistant Chief Accountants (SACA), and Accounting Branch Chiefs

#1 Health Care and Insurance – (202) 551-3710
AD - Jeffrey Riedler
SACA - Jim Rosenberg
Accounting Branch Chiefs: Jim Atkinson
Joe Roesler
Kevin Woody

#2 Consumer Products – (202) 551-3720
AD - H. Christopher Owings
SACA - Jim Allegretto
Accounting Branch Chiefs: Will Choi
Michael Moran
William Thompson

#3 Computers and OnLine Services – (202) 551-3730
AD - Barbara Jacobs
SACA - Craig Wilson
Accounting Branch Chiefs: Kathy Collins
Stephen Krikorian

#4 Natural Resources and Food – (202) 551-3740
AD - Roger Schwall
SACA - Brad Skinner
Accounting Branch Chiefs: Jill Davis
Karl Hiller
April Sifford

#5 Structured Finance, Transportation and Leisure – (202) 551-3750
AD - Max Webb
SACA - Joseph Foti
Accounting Branch Chiefs: Linda Cvrkel
Michael Fay
David Humphrey

#6 Manufacturing and Construction – (202) 551-3760
AD - Pam Long
SACA - John Hartz
Accounting Branch Chiefs: John Cash
Rufus Decker

#7 Financial Services – (202) 551-3770
AD - Todd Schiffman
SACA - Don Walker
Accounting Branch Chiefs: John Nolan
Kevin W. Vaughn
Hugh West

#8 Real Estate and Business Services – (202) 3780
AD - Karen Garnett
SACA - Linda Van Doorn
Accounting Branch Chiefs: Dan Gordon
Cicely LaMothe

#9 Office of Emerging Growth Companies – (202) 551-3790
AD - John Reynolds
SACA - Tia Jenkins
Accounting Branch Chiefs: Terence O’Brien
Hugh West

#10 Electronics and Machinery – (202) 551-3800
C. Division Employment Opportunities for Accountants

For more information about any of the positions or programs described below, contact Phyllis Hill, Program Support Specialist, at (202) 551-3550, or fax your resume to (202) 772-9215. You can also visit our website at http://www.sec.gov/jobs/jobs_accountants.shtml for current information about employment opportunities in the Division, salary and benefits, and how to apply for a federal job.

1. Staff Accountant

The full disclosure system for public companies is the foundation of the federal securities laws. Currently, the Division of Corporation Finance achieves the goal of improving the quality and timeliness of material disclosure to investors by selectively reviewing the periodic financial and other disclosures made by public companies. The Division is responsible for assuring full compliance with rules of the Commission that affect the disclosure of all public companies. Included are rules related to accelerated periodic reporting, certification of financial statements, use of non-GAAP financial measures, and MD&A disclosure about off-balance sheet arrangements and aggregate contractual obligations.

Corporation Finance accountants:

- review financial statements and disclosures for a variety of complex transactions, as well as interesting and unusual accounting, auditing and factual issues.
- review filings to identify potential or actual material accounting, auditing, financial reporting or disclosure deficiencies resulting from deviations from GAAP, GAAS or the accounting rules and policies of the SEC.
- interact with top professionals in the accounting and securities industries.
- influence accounting standards and practices.
- propose new and amended disclosure rules.
- field questions from registrants, prospective registrants and the public.
- offer guidance and counseling, either informally or in writing.

Accountants in the Division work directly with corporate officers, underwriters, outside accountants and counsel, as well as with division lawyers and financial analysts. Much of the work involves novel and unique accounting issues, financing and business structures.
Accountants in the Division review a variety of disclosure documents including registration statements; initial public offerings; proxy materials; annual reports; documents concerning tender offers; and filings related to mergers and acquisitions.

2. **Professional Accounting Fellowships**

The Division also has openings for up to ten positions for Professional Accounting Fellows for a nonrenewable term of two years. This program provides Accounting Fellows with in-depth exposure to the Commission’s full disclosure system administered by the Division. Accounting Fellows, working in a team with other staff accountants and lawyers, review filings by public registrants to identify material accounting, auditing or financial reporting deficiencies resulting from deviations from GAAP, GAAS, and SEC rules and regulations.

3. **Professional Academic Fellowships (Updated)**

The Commission offers fellowship opportunities in the Office of the Chief Accountant (2 fellowships), the Division of Corporation Finance (1 fellowship), and the Office of Economic Analysis (1 fellowship) for financial accounting and auditing professors; a fellowship typically lasts for 12 months (August 1-July 31). An academic fellowship at the SEC provides an unparalleled opportunity for a professor to be directly involved in the work of the Commission and to gain insight into the SEC’s oversight and regulatory processes. An SEC fellowship is a notable way to spend a sabbatical year or a leave of absence and offers a set of memorable experiences that will greatly enhance subsequent teaching and publication activities.

The Division’s fellowship, which originated about seven years ago, typically involves researching financial reporting issues in connection with Division policy or program initiatives, reviewing filings by public companies to identify significant accounting and disclosure problems, and developing and presenting training on emerging or controversial accounting issues for accountants and attorneys at the Commission. Requirements include a Master’s or Ph.D. and teaching experience in upper-level/advanced financial accounting courses. Expertise in quantitative analysis and finance, the ability to discuss issues in plain English, and a background in international accounting are plus factors.

While on sabbatical or leave of absence from the home university, an academic fellow maintains an employee relationship with the home institution, typically earning 12/9 of the usual 9-month academic salary (currently up to about $170,396), plus benefits and relocation expenses. [Note: The salary cap does not mean that an academic fellow’s maximum 12-month salary is $170,396. Rather, $170,396 is the maximum salary that the SEC will reimburse to the school (all normal university benefits will also be reimbursed). The employing university is permitted to pay the professor more than this amount.]

Indicate your initial interest and request more information by sending an e-mail to one or more current academic fellows in Office of the Chief Accountant (David Plumlee plumleed@sec.gov; Marlene Plumlee plumleem@sec.gov; Tom Noland nolandt@sec.gov), the Division of Corporation Finance (Parveen Gupta guptap@sec.gov), or Office of Economic
Analysis (Duane Seppi seppid@sec.gov; Yaniv Grinstein grinsteiny@sec.gov; Jennifer Marietta-Westberg westbergj@sec.gov). Feel free to contact the current academic fellows to discuss the nature of the position and the application process.

Application reviews for the 2007-2008 academic fellowships will begin in late 2006, and will continue until the positions are filled. Interviews will be conducted at the SEC headquarters in Washington, DC. Candidates’ travel expenses cannot be reimbursed. The SEC’s goal is to announce final selections by the Spring of 2007.

To find out more about the experiences of three previous academic fellows, see Thomas J. Linsmeier’s article in Accounting Horizons (September 1996) and articles by Steve Kolenda and Patricia Fairfield in the Financial Reporting Journal (Summer 2000.)