Current Accounting and Disclosure Issues in the Division of Corporation Finance

December 1, 2005

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U.S. Securities and Exchange Commission
Washington, D.C.

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

A. Final Rules Regarding Securities Offering Reform (Updated)

On June 29, 2005, the Commission voted to adopt modifications to the registration, communications, and offering processes under the Securities Act of 1933 (see Release No. 33-8591). The principal areas of the release are summarized below.

Categories of Issuers

In many cases, the amount of flexibility granted to issuers under the reforms is contingent on the characteristics of the issuer, including the type of issuer, the issuer's reporting history, and the issuer's equity market capitalization or amount of previously registered non-convertible securities, other than common equity. The reforms divide issuers into four categories:

- *Well-known seasoned issuer* - a new class of issuer that is current and timely in its Exchange Act reports for at least one year and has either $700 million of worldwide public common equity float or has issued $1 billion of non-convertible securities, other than common equity, in registered offerings for cash, in the preceding three years.
- *Seasoned issuer* - a primary shelf eligible issuer.
- *Unseasoned issuer* - an issuer that is required to file reports pursuant to Sections 13 or 15(d) of the Exchange Act, but is not a primary shelf eligible issuer.
- *Non-reporting issuer* - an issuer that is not required to file reports pursuant to Sections 13 or 15(d) of the Exchange Act (this would include issuers that file these reports voluntarily).

Liberalizing Communications Around the Time of Registered Offerings

The rules update and liberalize permitted offering activity and communications to allow more information to reach investors by revising the application of the "gun-jumping" provisions under the Securities Act. The cumulative effects of these rules are:

- Well-known seasoned issuers are permitted to engage at any time in oral and written communications, including use at any time of a new type of written communication called a "free writing prospectus," subject to enumerated conditions (including, in some cases, filing with the Commission).

- All reporting issuers are, at any time, permitted to continue to publish regularly released factual business information and forward-looking information.
- Non-reporting issuers are, at any time, permitted to continue to publish factual business information that is regularly released and intended for use by persons other than in their capacity as investors or potential investors.
- Communications by issuers more than 30 days before filing a registration statement are permitted so long as they do not reference a securities offering that is the subject of a registration statement.
- All issuers and other offering participants are permitted to use a free writing prospectus after the filing of the registration statement, subject to enumerated conditions (including, in some cases, filing with the Commission).
- The Rule 134 exclusion from the definition of prospectus is expanded to allow a broader category of routine communications regarding issuers, offerings and procedural matters, such as communications about the schedule for an offering or about account-opening procedures.
- The exemptions for research reports are expanded.

A number of these new rules include conditions of eligibility. Most of the rules, for example, are not be available to blank check companies, penny stock issuers, or shell companies.

The rules address the treatment under the Securities Act of electronic communications, including electronic road shows and information located on or hyperlinked to an issuer's website.

Liability Timing Issues

The Commission addressed the liability provisions under the Securities Act. In this regard, the Commission:

- Reaffirmed its interpretation and adopted an interpretive rule that, for purposes of disclosure liability under Section 12(a)(2) and Section 17(a)(2) of the Securities Act, when assessing whether a statement to an investor prior to or at the time of sale by a seller includes or represents a material misstatement or omits to state a material fact necessary to make the statement in light of the circumstances under which it was made, not misleading, information conveyed to the investor only after the time of sale should not be taken into account.
- Approved changes to the Securities Act procedures for shelf registration that ensure that prospectus supplements filed after the initial effective date of a registration statement will be included in the registration statement for Securities Act Section 11 liability purposes.
- Approved rules that establish a new Section 11 effective date for each takedown off a shelf registration statement for issuers and underwriters, but not for experts, directors, and signing officers. If an expert provides a new report or opinion in an Exchange Act report or in connection with the takedown that would require a

consent, however, there would be a new effective date for that expert.

Improvements to Registration Procedures

The rules make improvements to the shelf registration provisions that will modernize the operation of the shelf registration process under the Securities Act. The changes:

- Codify in a single rule the information that may be omitted from a base prospectus in a shelf registration statement at effectiveness and included later;
- Replace the requirement that issuers register only securities they intend to offer within two years with a requirement that the issuer update the registration statement with a new registration statement that is filed every three years;
- Eliminate restrictions on "at-the-market" equity offerings by seasoned issuers with a $75 million public float;
- Permit immediate takedowns of securities off of shelf registration statements;
- Permit issuers to use prospectus supplements (rather than post-effective amendments) to make material changes to the plan of distribution described in the base prospectus;
- For seasoned issuers with a $75 million public float, revise the requirement to identify selling security holders to permit selling security holders to be identified in prospectus supplements (rather than post-effective amendments), where the securities to be sold (or securities convertible into such securities) are outstanding when the registration statement is filed; and
- Establish a significantly more flexible version of shelf registration, referred to as "automatic shelf registration," for offerings by well-known seasoned issuers. Automatic shelf registration permits automatic effectiveness, pay-as-you-go registration fees, and the ability to exclude additional information from base prospectuses.

The rules also contain procedural changes that allow certain reporting issuers that are current in filing their Exchange Act reports to incorporate by reference previously filed Exchange Act reports and other materials into a Securities Act registration statement on Form S-1 or Form F-1.

Prospectus Delivery Reforms

The rules change the way in which the final prospectus delivery obligations under the Securities Act are satisfied by creating an "access equals delivery" model for final prospectuses. Under this model, filing a final prospectus with the Commission and complying with other conditions will enable offering participants to conduct securities offerings without printing and actually delivering final prospectuses. A cure provision for inadvertent failures to file is included. In addition, the rules include a separate requirement to notify investors that they purchased securities in a registered offering.

Required Disclosure in Exchange Act Reports

The rules require issuers to include the following in their Exchange Act periodic reports:

- For Form 10-K filers, disclosure of risk factors, where appropriate, with additional disclosure regarding risk factors in Form 10-Q;
- Disclosure regarding the issuer's status as a well-known seasoned issuer;
- Disclosure regarding the issuer's status as a "voluntary" filer of Exchange Act reports; and
- For "accelerated filers" and well-known seasoned issuers, disclosure in their reports of written staff comments that were issued more than 180 days before the end of the fiscal year to which the annual report relates, where those comments remain unresolved at the time of filing the annual report and the issuer believes those comments to be material.

The effective date of the rules is December 1, 2005.

- The Commission staff has posted questions and answers regarding the implementation and interpretation of the rules (see *Securities Offering Reform Transition Questions and Answers* at: http://www.sec.gov/divisions/corpfin/transitionfaq.htm and *Securities Offering Reform Questions and Answers at:* http://www.sec.gov/divisions/corpfin/faqs/securities_offering_reform_qa.pdf).

B. Regulatory Relief and Assistance for Hurricane Katrina Victims (New)

On September 15, 2005, the Commission issued an order providing emergency regulatory relief to investors, companies, and securities firms affected by Hurricane Katrina (see Release No. 34-52444). To address compliance issues caused by Hurricane Katrina and its aftermath, the order conditionally exempts affected persons from the requirements of the federal securities laws with regard to the following:

- Exchange Act filing requirements for the period from and including August 29, 2005 to October 14, 2005;
- Proxy and information statement delivery requirements for companies or other persons attempting to deliver materials to affected areas;
- Investment Company Act requirements for the transmittal to shareholders in affected areas of the annual and semi-annual reports of registered investment companies for a 90-day period;
- Transfer Agent compliance with Sections 17A and 17(f) of the Exchange Act; and
- Auditor independence requirements as they relate to auditors performing bookkeeping services for audit clients.

In addition, the Commission has directed the staff to take the following positions under the Exchange Act, the Securities Act and the Investment Advisers Act with regard to issues that may arise commonly for companies and other persons attempting to comply with their obligations under the federal securities laws:

- For purposes of the Form S-2 and Form S-3 eligibility (as well as well-known seasoned issuer status, which is based in part on Form S-3 eligibility) of a company relying on the exemptive order, any of that company's Exchange Act reports that would have been required to be filed during the period from and including August 29, 2005 to October 14, 2005 will be considered to have a due date of October 17, 2005. Such a company will, therefore, be considered:
    - current in its Exchange Act reports prior to October 17, 2005 if it was current in its Exchange Act reports as of August 28, 2005; and
    - current in its Exchange Act reports as of October 17, 2005 if it was current in its Exchange Act reports as of August 28, 2005 and it has made any filings required during the period from and including August 29, 2005 to October 14, 2005;
    - timely in its Exchange Act reports prior to October 17, 2005 if it was timely in its Exchange Act reports as of August 28, 2005; and
    - timely in its Exchange Act reports as of October 17, 2005 if it was timely in its Exchange Act reports as of August 28, 2005 and it has made any filings required during the period from and including August 29, 2005 to October 14, 2005 on or before October 17, 2005.
- For purposes of the Form S-8 eligibility requirements and the current public information eligibility requirements of Rule 144(c), a company relying on the exemptive order will be considered:
    - current in its Exchange Act reports prior to October 17, 2005 if it was current in its Exchange Act reports as of August 28, 2005; and
    - current in its Exchange Act reports as of October 17, 2005 if it was current in its Exchange Act reports as of August 28, 2005 and it has made any filings required during the period from and including August 29, 2005 to October 14, 2005.
- Companies that are provided extended due dates for Exchange Act annual reports or quarterly reports pursuant to the Order will be considered to have a due date of October 17, 2005 for those reports for purposes of Exchange Act Rule 12b-25. As such, those companies will be permitted to rely on Rule 12b-25 where they are unable to file the required reports on or before October 17, 2005.
- For a 90 calendar day period beginning on August 29, 2005, a registered open-end investment company and a registered unit investment trust, will be considered to have satisfied the requirements of Section 5(b)(2) of the Securities Act to deliver a statutory prospectus to an investor, provided that: (1) the sale of shares to the investor was not an initial purchase by the investor of shares of the company or unit investment trust; (2) the investor's mailing address for delivery, as listed in the records of the company or unit investment trust, has a zip code for which the United States Postal Service has suspended mail service, as a result of Hurricane Katrina, of the type or class customarily used by the company or unit investment trust, to deliver statutory prospectuses; and (3) the company, or unit investment trust, or other person promptly delivers the statutory prospectus (a) if requested by the investor, or (b) at the earlier of the end of the 90-day period or the resumption of the applicable mail service.

- For a 90 calendar day period beginning on August 29, 2005, a registered investment adviser will be considered to have satisfied the requirements of Section 204 of the Advisers Act and Rule 204-3(c) thereunder to deliver the written disclosure statement required thereunder to its advisory client, provided that: (1) the client's mailing address for delivery, as listed in the records of the investment adviser, has a zip code for which the United States Postal Service has suspended mail service, as a result of Hurricane Katrina, of the type or class customarily used by the adviser to deliver written disclosure statements; and (2) the investment adviser or other person promptly delivers the written disclosure statement (a) if requested by the client or (b) at the earlier of the end of the 90-day period or the resumption of the applicable mail service.

Companies and other affected persons may require additional or different assistance in their efforts to comply with the requirements of the federal securities laws. Commission staff will address specific issues, such as difficulty completing audits or complying with the internal control requirements adopted pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, and any disclosure-related issues on a case-by-case basis in light of their fact-specific nature. Any companies, transfer agents, registered investment companies, registered investment advisers, security holders, or other persons requiring additional assistance are encouraged to contact Commission staff for individual relief or interpretive guidance. For this purpose, the Commission has established both telephone and e-mail hotlines to provide immediate responses to questions or to hear from those that want to advise the Commission of their needs:

- Telephone calls should be directed to (202) 551-3300.
- E-mail should be directed to cfhotline@sec.gov.

C. Employee Stock Options (New)

1. Amendment of Compliance Dates for Statement of Financial Accounting Standards No. 123R, *Share Based Payment*

On April 14, 2005, the Commission adopted a rule that changed the required compliance dates for Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* (SFAS 123R) (see Release No. 33-8568). Under SFAS 123R, registrants were required to implement the standard as of the beginning of the first interim or annual period that begins after June 15, 2005, or after December 15, 2005 for small business issuers. Calendar year-end companies that are not small business issuers, therefore, would have been permitted to follow the pre-existing accounting literature for the first and second quarters of 2005, but required to follow SFAS 123R for their third quarter reports.

The Commission's new rule allows companies to delay implementing SFAS 123R until the beginning of their next fiscal year, instead of the next reporting period, that begins after June 15, 2005, or December 15, 2005 for small business issuers. This means, for example, that the financial statements for a calendar year-end company do not need to comply with SFAS 123R until the interim financial statements for the first quarter of 2006 are filed with the Commission. The financial statements for a company, other than a small business issuer, with a June 30 year-end, however, must comply with SFAS 123R when the interim financial statements for the quarter beginning July 1, 2005 are filed with the Commission.

The Commission's new rule does not change the accounting required by SFAS 123R; it changes only the dates for compliance with the standard.

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.

The statements are available at: http://www.sec.gov/news/press/2005-129.htm and http://www.sec.gov/news/speech/spch090905dtn.htm. The Commission's Office of Economic 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.

D. Final Rule regarding IFRS First-time Adopters (Updated)

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.

E. 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:
  - no or nominal assets;
  - assets consisting solely of cash and cash equivalents; or
  - 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 will 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 took effect on August 22, 2005, except for new Form 8-K Item 5.06, which took effect on November 7, 2005.

F. Final Rules Regarding Asset-Backed Securities

On December 15, 2004, the Commission voted to adopt new and amended rules and forms to address comprehensively the registration, disclosure and reporting requirements for asset-backed securities under the Securities Act and the Exchange Act (see Release No. 34-50905). Principally, the amendments accomplish the following:

- update and clarify the Securities Act registration requirements for offerings of asset-backed securities, including expanding the types of asset-backed securities that may be offered in delayed primary offerings on Form S-3;
- consolidate and codify existing interpretive positions that allow modified Exchange Act reporting that is more tailored and relevant to asset-backed securities;
- provide tailored disclosure guidance and requirements for Securities Act and Exchange Act filings involving asset-backed securities; and
- streamline and codify existing interpretive positions that permit the use of written communications in a registered offering of asset-backed securities in addition to the statutory registration statement prospectus.

The amendments are intended to clarify the regulatory requirements for asset-backed securities in order to increase market efficiency and transparency and provide more certainty for the overall ABS market and its participants. In response to comments, the amendments have delayed compliance dates until January 1, 2006, to allow market participants to prepare for the new requirements.

The full text of the release can be found at http://www.sec.gov/rules/final/33-8518.htm.

G. Final Rules and Concept Release Regarding the Use of Tagged Data

On February 3, 2005, the Commission adopted rules, in Release No. 33-8529, to establish a voluntary program related to eXtensible Business Reporting Language (XBRL). Registrants may voluntarily furnish XBRL data in an exhibit to specified EDGAR filings under the Exchange Act and the Investment Company Act. This program begins with the 2004 calendar year-end reporting season. The primary purpose of the voluntary program is to assess XBRL technology, including both the ability of registrants to tag their financial information using XBRL and the benefits of using tagged data for analysis.

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.

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.

Additional information on the Commission's tagged data and XBRL initiatives can be found at http://www.sec.gov/spotlight/xbrl.htm.

H. Accelerated Filer (Updated)

1. Summary of Currently Proposed Rule and Final Rules

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 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 on September 21, 2005 to propose amendments to the periodic report filing deadlines and the Exchange Act Rule 12b-2 definition of an "accelerated filer" (see Release No. 33-8617). The proposed amendments would 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 proposed amendments also would redefine "accelerated filers" as companies that have at least $75 million but less than $700 million in public float. The proposals also would:

- create a new category of companies called "large accelerated filers";
- adjust the definition of "accelerated filers";
- cause large accelerated filers to become subject to a 60-day Form 10-K annual report deadline and a 40-day Form 10-Q quarterly report deadline next year and in subsequent years; and
- maintain the current 75-day Form 10-K annual report deadline and 40-day Form 10-Q quarterly report deadline for accelerated filers next year and in subsequent years;
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The proposed amendments also would modify the procedures by which accelerated filers can exit accelerated filer status by permitting an accelerated filer whose public float has dropped below $25 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 proposed amendments similarly would permit a large accelerated filer to exit large accelerated filer status once its public float has dropped below $75 million.

Comments on the proposed amendments should have been received on or before October 31, 2005. The full text of the release can be found at http://www.sec.gov/rules/proposed/33-8617.pdf.

2. Summary of Current 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 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 registrant remains an accelerated filer until it becomes eligible to file small business reports. In order to become eligible to file small business reports, a registrant's non-affiliated float and its annual revenues cannot exceed $25 million for two consecutive years. Thereafter, a registrant would again have to satisfy the accelerated filer definition to become subject to the accelerated filing requirements.

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 accelerated filing rule if it meets the definition of an accelerated filer.

Accelerated Filing Phase-In Schedule (Subject to Recent Proposed Revisions)

Registrants meeting the accelerated filer criteria are required to accelerate their 10-K and 10-Q filings on the following schedule.

For Fiscal Years Ending On Or After	Form 10-Q Deadline	Form 10-K Deadline
December 15, 2003	45 days after fiscal quarter end	75 days after fiscal year end
December 15, 2004	40 days after fiscal quarter end	75 days after fiscal year end
December 15, 2005	40 days after fiscal quarter end	60 days after fiscal year end
December 15, 2006	35 days after fiscal quarter end	60 days after fiscal year end

The deadlines provide for a scheduled phase-in over a defined period in time, so that all registrants who meet the definition of an accelerated filer have the same reporting deadlines no matter when they became an accelerated filer.

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.

Accelerated filers can file their Article 12 financial statement schedules by amendment within 30 days following the due date of their Form 10-K. Consequently, at the end of the phase-in period, accelerated filers will be required to file the schedules within 90 days of the end of the fiscal year.

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.

Forms 10-K and 10-Q Disclosures

The new rules require that all Exchange Act registrants filing on Form 10-K include new cover page disclosures in their Forms 10-K for fiscal years ending on or after December 15, 2002. The amended cover page requires the registrant to indicate by check mark either that it is or is not an accelerated filer and to disclose its 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 accelerated filing status disclosure is also required on Form 10-Q.

If a registrant’s cover page to its Form 10-K 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 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 an accelerated filer. In this scenario, the registrant would not qualify as 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 (Subject to Recent Proposed Revisions)

In addition to accelerating the Form 10-Q filing deadlines, the new rules accelerate 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 an accelerated filer, its interim financial statements must meet the following:

For Fiscal Years Ending On Or After	Interim Financial Statements Cannot be Older Than
December 15, 2003	134 days
December 15, 2004	129 days
December 15, 2005	129 days
December 15, 2006	124 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 according to the following schedule:

For Fiscal Years Ending On Or After	Audited Year End Financial Statements Must be Included by
December 15, 2003	75 days after year-end
December 15, 2004	75 days after year-end
December 15, 2005	60 days after year-end

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 an accelerated filer. Therefore, an acquirer that is either an accelerated or non-accelerated filer 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. 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.

I. Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports (Updated)

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.

The compliance schedule for the rules regarding management's report on internal controls was revised in February 2004 (Release No. 33-8392), revised again on March 2, 2005 (Release No. 33-8545), and on September 21, 2005 (Release No. 33-8618). As a result of Release No. 33-8392, an accelerated filer must begin to comply with the rules regarding management's report on internal controls for its first fiscal year ending on or after Nov. 15, 2004 (originally June 15, 2004). As a result of Release No. 33-8545, a foreign private issuer that is an accelerated filer must begin to comply with these requirements for its first fiscal year ending on or after July 15, 2006 (originally April 15, 2005). As a result of Release No. 33-8618, a non-accelerated filer (whether a domestic company or a foreign private issuer) must begin to comply with these requirements for its first fiscal year ending on or after July 15, 2007 (originally April 15, 2005). As noted in Section I.D. of this outline, accelerated filer status is determined at the end of a registrant's fiscal year based on certain conditions, including its non-affiliated common equity public float as of the last business day of its most recently completed second fiscal quarter. Therefore, there may be registrants who are currently non-accelerated filers who become accelerated filers as of the end of their next fiscal year that will not be eligible for further extension under Release No. 33-8545.

The Commission also is soliciting public comment on several questions about the application of the internal control reporting requirements including questions regarding the amount of time and expense that non- accelerated filers have incurred to date to prepare for compliance with the internal control reporting requirements. Comments should have been received by the Commission on or before October 31, 2005. The full text of the release can be found at http://www.sec.gov/rules/final/33-8618.pdf.

The Commission held a public roundtable on April 13, 2005 on Implementation of Internal Control Reporting Provisions, and received extensive feedback. Two messages have been clear from the feedback. First, compliance with Section 404 is producing benefits, including a heightened focus on internal controls at the top levels of public companies. Second, implementation in the first year resulted in significant costs. 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.

As a result of the concerns expressed, 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.*

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.

In addition, the Commission staff has received specific questions regarding the implementation and interpretation of the rules. For answers to some of the questions most frequently posed, please see *Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Frequently Asked Questions (revised October 6, 2004)* at http://www.sec.gov/info/accountants/controlfaq1004.htm and *Exemptive Order on Management's Report on Internal Control over Financial Reporting and Related Auditor Report, Frequently Asked Questions (January 21, 2005)* at http://www.sec.gov/divisions/corpfin/faq012105.htm. The PCAOB's Office of Chief Auditor has also issued staff questions and answers related to PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* available at http://www.pcaobus.com/Standards/Staff_Questions_and_Answers/index.asp.

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 October 26, 2005, COSO published for comment 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, entitled Guidance for Smaller Public Companies Reporting on Internal Control Over Financial Reporting, is available at www.coso.org. Comments should be directed to COSO through its website by Dec. 31, 2005.

J. Management's Discussion and Analysis

1. Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations

Section 401(a) of the Sarbanes-Oxley Act added Section 13(j) to the Securities Exchange Act of 1934, which required the Commission to adopt final rules by January 26, 2003, to require each annual and quarterly financial report required to be filed with the Commission, to disclose "all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the registrant with unconsolidated entities or other persons, that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses."

On January 22, 2003, the Commission adopted rule amendments to implement Section 401 of the Sarbanes-Oxley Act (see Release No. 34-47264). The amendments, which are effective, require a registrant to provide an explanation of its off-balance sheet arrangements in a separately captioned subsection of the MD&A section in its disclosure documents. The amendments also require registrants (other than small business issuers) to provide an overview of certain known contractual obligations in a tabular format.

The amendments include a definition of off-balance sheet arrangements that primarily targets the means through which registrants typically structure off-balance sheet transactions or otherwise incur risks of loss that are not fully 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 amendments require disclosure of off-balance sheet arrangements that either have, or are reasonably likely to have, a current or future effect on the registrant's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors. That disclosure threshold is consistent with the existing disclosure threshold under which information that could have a material effect on financial condition, changes in financial condition or results of operations must be included in MD&A.

The amendments require disclosure of the following specified information to the extent necessary to an understanding of off-balance sheet arrangements and their material effects:

- the nature and business purpose of the registrant's off-balance sheet arrangements,
- the importance to the registrant for liquidity, capital resources, market risk or credit risk support or other benefits,
- the financial impact and exposure to risk, and
- known events, demands, commitments, trends or uncertainties that implicate the registrant's ability to benefit from its off-balance sheet arrangements.

Consistent with other MD&A requirements, the amendments contain a principles-based requirement that a registrant provide such other information that it believes is necessary for an understanding of its off-balance sheet arrangements and their material effects. In addition, the amendments include a requirement for registrants to disclose, in a tabular format, the amounts of payments due under specified contractual obligations, aggregated by category of contractual obligation, for specified time periods. The categories of contractual obligations to be included in the table are defined by reference to the applicable accounting literature.

2. SEC Staff Report on Off-Balance Sheet Arrangements, Special Purpose Entities and Related Issues (New)

On June 15, 2005, the SEC staff released a 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 (see the full text of the staff study at www.sec.gov/news/studies/soxoffbalancerpt.pdf.). The report was prepared pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002. As required by that Act, the report was submitted to the President, the Committee on Banking, Housing and Urban Affairs of the Senate, and the Committee on Financial Services of the House of Representatives. The staff report includes an analysis of the filings of issuers as well as an analysis of pertinent U.S. generally accepted accounting principles and Commission disclosure rules. The report describes the staff's study, details its findings, and provides recommendations.

The staff took a broad approach to the scope of the report by including a review of a range of topics with potential off-balance sheet implications, including consolidation issues, transfers of financial assets with continuing involvement, retirement arrangements, contractual obligations, leases, contingent liabilities and derivatives, as well as a discussion of special purpose entities (SPEs).

The report identifies several goals for those involved in the financial reporting community, including efforts to:

- discourage transactions and transaction structures motivated primarily and largely by accounting and reporting considerations, rather than economics;
- expand the use of objectives-oriented standards;
- improve the consistency and relevance of disclosures; and
- focus financial reporting on communication with investors, rather than just compliance with rules.

The report also provides the following staff positions and recommendations regarding certain changes in accounting and reporting requirements, each of which complement one or more of the goals mentioned above:

- The staff recommends the accounting guidance for defined-benefit pension plans and other post-retirement benefit plans be reconsidered. The trusts that administer these plans are currently exempt from consolidation by the issuers that sponsor them, effectively resulting in the netting of assets and liabilities in the balance sheet. In addition, issuers have the option to delay recognition of certain gains and losses related to the retirement obligations and the assets used to fund these obligations.

- The staff recommends that the accounting guidance for leases be reconsidered. The current accounting for leases takes an "all or nothing" approach to recognizing leases on the balance sheet. This results in a clustering of lease arrangements such that their terms approach, but do not cross, the "bright lines" in the accounting guidance that would require a liability to be recognized. As a consequence, arrangements with similar economic outcomes are accounted for very differently.
- The staff recommends the continued exploration of the feasibility of reporting all financial instruments at fair value.
- The staff recommends that the Financial Accounting Standards Board continue its work on the accounting guidance that determines whether an issuer would consolidate other entities-including SPEs-in which the issuer has an ownership or other interest.
- The staff believes that, in general, certain disclosures in the filings of issuers could be better organized and integrated.

3. MD&A Interpretive Release

On December 19, 2003, the Commission issued an interpretive release providing guidance regarding MD&A disclosure in registrants' disclosure documents. The guidance reminds registrants of existing disclosure requirements and provides additional guidance, designed to elicit more informative and transparent MD&A, that satisfies the principal objectives of MD&A:

- to provide a narrative explanation of a registrant's financial statements that enables investors to see the registrant through the eyes of management,
- to enhance the overall financial disclosure and provide the context within which financial information should be analyzed, and
- to provide information about the quality of, and potential variability of, a registrant's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance.

The guidance emphasizes that MD&A should not be merely a recitation of financial statements in narrative form or an otherwise uninformative series of technical responses to MD&A requirements, neither of which provides the important management perspective called for by MD&A. Instead, the release encourages top-level management involvement in the drafting of MD&A, and provides guidance regarding:

- the overall presentation and focus of MD&A (including through executive-level overviews, a focus on the most important information and a reduction of duplicative information),
- emphasis on analysis of financial information,
- known material trends and uncertainties,

- key performance indicators, including non-financial indicators,
- liquidity and capital resources, and
- critical accounting estimates (see also Financial Reporting Release (FRR) No. 60, *Cautionary Advice Regarding Disclosure About Critical Accounting Policies* (http://www.sec.gov/rules/other/33-8040.htm) and Release No. 34-45907, *Proposed Rule: Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies*).

The release does not create new legal requirements, nor does it modify existing legal requirements. A copy of the release can be found on the Commission's Web site at http://www.sec.gov/rules/interp/33-8350.htm under Regulatory Actions / Interpretive Releases.

K. Rule Proposals Related to Proxy Materials

1. Proposals Regarding Security Holder Director Nominations

On October 8, 2003, the Commission voted to propose rule changes that would, under certain circumstances, require registrants to include in their proxy materials security holder nominees for election as director (see Release No. 34-48626). These proposed rules are intended to improve disclosure to security holders to enhance their ability to participate meaningfully in the proxy process for the nomination and election of directors. The proposed rules would not provide security holders with the right to nominate directors where it is prohibited by state law. Instead, the proposed rules are intended to create a mechanism for nominees of long-term security holders, or groups of long-term security holders, with significant holdings to be included in company proxy materials where there are indications that security holders need such access to further an effective proxy process. This mechanism would apply in those instances where evidence suggests that the company has been unresponsive to security holder concerns as they relate to the proxy process. The proposed rules would enable security holders to engage in limited solicitations to form nominating security holder groups and engage in solicitations in support of their nominees without disseminating a proxy statement. The proposed rules also would establish the filing requirements under the Exchange Act for nominating security holders.

2. 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. Comments should be received on or before the 60th day after publication in the Federal Register.

L. Public Release of Comment Letters and Responses (New)

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. 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.

M. Recent Enforcement Actions Involving MD&A (New)

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 for the 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.

N. Recent Enforcement Actions Involving GAAP (New)

1. Enforcement Actions involving <u>Warnaco</u>

On May 11, 2004, the Commission settled enforcement proceedings against The Warnaco Group, Inc., a major apparel manufacturer, its former CEO Linda Wachner, former CFO William Finkelstein, former general counsel Stanley Silverstein, and the company's former audit firm, PwC. Warnaco was charged with securities fraud for issuing a false and misleading press release about its financial results on March 2, 1999, and Finkelstein with aiding and abetting the company's fraud. The Commission also charged Warnaco, Finkelstein, Wachner, and Silverstein for their roles in Warnaco's misleading disclosure in its annual report for 1998. In addition, the Commission charged PwC, Warnaco's audit firm at the time, with aiding and abetting Warnaco's reporting violations in the 1998 annual report.

The Commission found that a March 1999 press release, which reported "record" results for 1998, failed to inform investors that Warnaco had discovered a $145 million inventory overstatement that would require the company to restate and significantly lower its financial results for the prior three years. Instead, Warnaco falsely characterized the inventory restatement as the write-off of deferred start-up costs under a new accounting pronouncement. In fact, the overstatement had been caused by serious defects in Warnaco's inventory accounting and internal control systems and did not involve deferred start-up costs.

A month after issuing the fraudulent press release, Warnaco filed a misleading annual report for 1998. Although the annual report correctly accounted for the $145 million restatement, Warnaco failed to inform investors of the true cause of the restatement, instead claiming that the restatement resulted from the write-off of "start-up related" costs. Warnaco's senior management, Wachner, Finkelstein, and Silverstein, knew or should have known that the restatement resulted from material flaws in the company's cost accounting and internal control systems at one of its divisions. Nevertheless, all three approved the annual report, and Wachner and Finkelstein signed it.

PwC, which audited Warnaco's 1998 financial statements, failed to object to Warnaco's mischaracterization of the inventory overstatement as "start-up related" costs and included the misleading description of the restatement into its audit report.

In addition to agreeing to an injunction against future violations of the federal securities laws, Finkelstein agreed to disgorge his bonus for 1998, including interest, of $189,464 and pay a $75,000 civil penalty, for a total payment of $264,464. He also consented to an order prohibiting him from acting as an officer or director of a public company for four years. Wachner and Silverstein also agreed to disgorge their bonuses for 1998, along with prejudgment interest, of $1,328,444 and $165,772, respectively.

Warnaco was required to hire an independent consultant to perform a complete review of the company's internal controls and policies relating to its inventory systems, internal audit, financial reporting and other accounting functions. Warnaco also agreed to adopt the recommendations of the independent consultant within 180 days.

PwC consented to pay a $2.4 million penalty in the federal court action. The Commission censured PwC under Rule 102(e), after finding that that PwC willfully aided and abetted Warnaco's violation of Section 13(a) of the Exchange Act and Rules 12b-20 and 13a-1.

See AAERs-2005 through 2007 for more details.

2. Enforcement Actions involving Adelphia Communications Corporation

On April 25, 2005, the Commission settled a civil enforcement action against Adelphia Communications Corporation, its founder John J. Rigas, and his three sons, Timothy, Michael and James P. Rigas, in one of the most extensive financial frauds at a public company. On April 26, 2005, the Commission also settled proceedings against the company's auditors Deloitte & Touche (D&T) by censuring D&T for improper professional conduct under Rule 102(e) and fining D&T $25 million. D&T also agreed to pay an additional $25 million into a fund to compensate victims of Adelphia's fraud. In addition, D&T agreed to substantive undertakings designed to address its audit of high-risk clients.

The Commission's complaint charged that Adelphia, at the direction of the Rigases, (1) fraudulently excluded $1.6 billion in co-borrowing debt from its consolidated financial statements by shifting the debt to the books of off-balance sheet affiliates, the co-borrowers; (2) falsified operating statistics and inflated earnings to meet Wall Street estimates; and (3) concealed rampant self-dealing by the Rigas family, including the undisclosed use of corporate funds for purchases of Adelphia stock and luxury condominiums, by, among other methods, improperly netting related party payables ($1.348 billion at December 31, 2000) and receivables ($1.351 billion at December 31, 2000).

Under the settlement agreement, the Rigas family members forfeited over $1.5 billion in assets that they derived from the fraud, including the Rigas family's interests in certain cable properties. Upon the completion of forfeiture proceedings, Adelphia will obtain title to those cable properties and, at or around the time of Adelphia's emergence from Chapter 11, will pay $715 million into a victim fund.

The individual Rigas family members were barred for life from acting as officers or directors of a public company. Also under the settlement agreement, Adelphia and the Rigas family members agreed to entry of permanent injunctions enjoining them from the antifraud, periodic reporting, and record keeping and internal control provisions of the federal securities laws.

See AAER-2237 and AAER-2326 for more details.

3. Enforcement Actions involving <u>Dollar General</u>

On April 7, 2005, the Commission settled its enforcement action charging Dollar General Corporation and various former executives with accounting fraud. The Commission's complaint alleged that, during its fiscal years 1998 through 2001, Dollar General engaged in fraudulent or improper accounting practices in violation of GAAP which ultimately resulted in a restatement of Dollar General's financial statements in January 2002. The restatement reduced the company's pre-tax income by approximately $143 million, or about 30 cents per share, over the restated period.

The complaint alleges that Dollar General's misconduct included: (1) intentionally underreporting at least $10 million in import freight expenses for the Company's fiscal year 1999; (2) engaging in an $11 million sham sale of outdated, essentially worthless, Omron cash registers in the Company's fiscal year 2000 fourth quarter; (3) overstating cash accounts; (4) manipulating the Company's reported earnings through the use of a general reserve or "rainy day" account; (5) failing to maintain accurate books and records and filing inaccurate financial reports with the Commission; and (6) failing to maintain adequate internal accounting controls. The complaint also alleges that some of the fraudulent or improper accounting practices were caused by, or known to, former senior executives and accounting personnel who were motivated to report earnings that met or exceeded analysts' expectations and to maintain employee bonuses. 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, that it would not have met if it had properly recognized the freight expenses in 1999.

The complaint alleges that Dollar General's accounting staff determined that the company should have recognized $13.4 million in freight expenses in fiscal 1999. Rather than recognizing all the expense in fiscal year 1999, the company recorded freight expenses of $4 million in fiscal year 1999 and recognized the remaining $9.4 million ratably during fiscal year 2000. In an attempt to hide part of the improper deferral from the Company's auditors, accounting staff moved $1.3 million of the $9.4 million to the miscellaneous accrued liabilities account, widely known at Dollar General as the "Rainy Day Fund," and $2.7 million of the $9.4 million to corporate bank clearing accounts.

Dollar General consented to the entry of a final judgment permanently enjoining it from future violations of the antifraud, books and records, internal controls, and periodic reporting provisions of the federal securities laws. In addition, Dollar General agreed to pay $1 in disgorgement and a civil penalty of $10 million. Settlements by three company officers included permanent injunctions, permanent or temporary bars against practicing before the Commission or acting as an officer or director of a public company, and fines and penalties of approximately $1.4 million.

See AAER-2226 for more details. Charges against Dollar General's former CFO are pending.

4. Enforcement Actions involving Bristol-Myers Squibb Company

On Aug. 4, 2004, the Commission settled its civil enforcement action against Bristol-Myers Squibb Company. BMS agreed to pay $150 million dollars and perform numerous remedial undertakings, including the appointment of an independent adviser to review and monitor its accounting practices, financial reporting and internal controls. The Commission's complaint alleged that BMS engaged in a fraudulent earnings management scheme that deceived investors about the true performance, profitability and growth trends of the company and its U.S. medicines business. According to the Commission's complaint, BMS inflated its results primarily by (1) stuffing its distribution channels with millions of dollars of excess inventory near the end of each quarter to artificially inflate its financial results and meet its internal targets and the consensus estimate of analysts and (2) improperly recognizing upon shipment revenue from specially incentivized consignment-like sales associated with the channel stuffing.

The complaint alleges that BMS sold excessive amounts of its pharmaceutical products to wholesalers ahead of normal orders and improperly recognized revenue from $1.5 billion of such sales to its two largest wholesalers from the first quarter of 2000 through the fourth quarter of 2001. BMS engaged in this fraudulent scheme to inflate Bristol-Myers' sales and earnings in order to meet or exceed internal sales and earnings targets and analysts' earnings estimates. In addition, when BMS earnings results still fell short of its internal targets and analysts' estimates, the company used "cookie jar" reserves to further inflate its earnings.

In addition, BMS did not disclose that: (1) it was stuffing its distribution channels with millions of dollars of excess inventory near the end of each quarter to artificially inflate its financial results and meet its internal targets and the consensus estimate of analysts; (2) it stuffed its distribution channel by using financial incentives to wholesalers to induce them to buy excess inventory; (3) it was covering the costs its two largest wholesalers incurred from carrying the excess inventory and guaranteeing those wholesalers a specified return on any excess inventory they agreed to take, until they sold the products; (4) channel-stuffing was causing an unusual buildup in excess inventory; and (5) this unusual buildup in excess inventory posed a material risk to BMS' future sales and earnings.

The Commission's complaint also alleges that BMS circumvented or failed to maintain a system of internal accounting controls sufficient to prevent material misstatements in its books, records, accounts, and financial statements. Specifically, BMS internal controls over revenue recognition, Medicaid and prime vendor rebate liabilities, divestiture reserves, and other accounting items were inadequate.

On June 28, 2004 the company filed a Form 10-K/A to restate its financial statements for the three years ended December 31, 2001 which reflected the sales as consignment sales. As a result of the restatement for these and various other errors, pre-tax income from continuing operations decreased 31% in 2001, 7% in 2000 and 9% in 1999. See AAER-2075 for more details.

On August 22, 2005, the Commission filed civil fraud charges against two former Bristol-Myers Squibb officers Frederick Schiff, former CFO and Richard Lane, former President of the company's Worldwide Medicine Group for creating a fraudulent earnings management scheme that deceived investors about the true performance, profitability and growth trends of the company and its U.S. medicines business. Those charges are pending. See AAER-2294 for more details.

II. Other Current Accounting and Disclosure Issues

A. Dividend Policy Disclosures

The staff believes that certain disclosures are necessary in registration statements for initial public offerings by new registrants that include statements regarding their intention to pay future dividends. This issue first arose when companies began registering a new type of security called the income deposit security or IDS. Since then, the idea of "promised dividends" has expanded to other offerings including those of common stock. The companies making these types of offerings tend to be low-growth, mature companies with stable cash flows and little technology risk. Most of the offerings indicate that they will pay out cash in excess of operating needs as dividends.

Initial public offerings of master limited partnerships (MLP) should include similar disclosures. In the case of the MLP offerings, the registration statement typically states that the MLP will distribute all available cash flow to unit holders. However, similar to the common stock offerings discussed above, the distributions are generally not guaranteed since the partnership agreement can be modified by the majority of the common unit holders. The current owners (prior to the IPO) will likely still have significant control and the ability to unilaterally modify the partnership agreement.

The staff believes the following disclosures are necessary in registration statements for initial public offerings where the registrant indicates its intention to pay out a significant amount of dividends:

- detailed dividend policy description;
- discussion of material risks and limitations, including:
  - the fact that the distribution rate could be changed or eliminated at any time,
  - the impact of debt covenants and state laws on proposed dividend policy,
  - the risks of paying out all excess cash as dividends on growth, and
  - the impact on future debt repayment;
- forward-looking information about cash available for distribution; and
- disclosures supporting whether the registrant would have been able to achieve its distribution policy historically if the new policy had been in place at that time.

The forward-looking information about cash available for distribution should include a reconciliation of expected cash earnings to cash available for distribution. This reconciliation should start with a measure that the registrant considers to be highly correlated to cash. In some situations, it may be appropriate for a registrant to start with a non-GAAP measure such as EBITDA (earnings before interest, taxes, depreciation and amortization), assuming the registrant is able to assert that this measure is highly correlated to cash. Adjusted EBITDA also may be appropriate if calculated consistently with the measure contained in the registrant's debt covenants and the registrant is able to assert that the measure is highly correlated to cash.

The historical information supporting whether the registrant would have been able to achieve the proposed distribution policy should include a reconciliation of GAAP cash flows from operating activities to cash available for distributions. This reconciliation also should include reconciling items for things such as the additional costs associated with being a public company and adjustments for changes in interest expense expected as a result of the initial public offering or recapitalization transactions occurring concurrently with the initial public offering. Registrants should include detailed disclosures surrounding the assumptions used in deriving these amounts. Additionally, if the registrant would not have been able to pay the dividends at the intended level based on historical amounts, the registrant should clearly disclose why they believes it will be able to pay the dividends going forward.

Registrants also should include detailed disclosures regarding the assumptions used in arriving at the forward-looking information, including the risks and expected outcomes if expected results are not achieved. This disclosure may take the form of a bullet point list of assumptions with discussion of any changes from historical amounts. The registrant should discuss any impact on compliance with debt covenants based on the forward-looking operating results and expected cash flow information. MD&A disclosure also should include the intended dividend policy for the next year and how the registrant expects to fund the distribution.

B. Classification and Measurement of Warrants and Embedded Conversion Features (New)

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. 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*. This issue has been the subject of staff reviews in recent months.

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 paragraphs 12 -32 of EITF 00-19 to determine whether the instrument should be accounted for as a liability or an equity instrument. Registrants should ensure they have appropriately analyzed all warrant and registration rights agreements in considering the appropriate classification and accounting for their warrants.

The two most common reasons that warrants should be accounted for 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 if a registration statement covering the shares underlying the warrants was not declared effective by a certain date; and (2) the warrants contained registration rights where significant liquidated damages could be required to be paid to the holder of the instrument in the event the issuer fails to register the shares under a preset timeframe, or in some cases, where the registration statement fails to remain effective 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. The issuer of the warrants must analyze paragraph 16 of EITF 00-19 to determine whether the liquidated damages are meant to compensate the holder for the difference between a registered share and an unregistered share, which may require significant judgment. The EITF is currently deliberating the effect of certain issues related to freestanding warrants; registrants should monitor the progress of the FASB and EITF on these issues (see the deliberations of Issue 05-4).

Note that 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 penalties related to the lack of an effective registration statement will occur, or how significant they could become, is not a factor. The registrant is required to determine the maximum penalty that could occur in analyzing this provision under paragraph 16 of EITF 00-19.

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' equity. 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".*) 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 12-32 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 fact that (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 agreements contain registration rights where significant liquidated damages could be required to be paid to the holder of the instrument in the event the issuer fails to register the shares issuable upon conversion under a preset timeframe, or in some cases, where the registration statement fails to remain effective for a preset time period. In the case of (1) 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 registration rights associated with these agreements, and properly accounted for these instruments under all applicable accounting literature.

C. Statement of Cash Flows

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. As such, registrants should give significant 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. While the staff believes a statement of cash flows using the direct method provides investors with more useful information than the short-cut indirect method, we recognize that most registrants use the indirect method. Therefore, we encourage registrants to put more 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. Classification of Cash Receipts from Inventory Sales

Registrants may finance the sale of inventory in various ways, such as on account or with a note or sales-type lease receivable (whether long-or short-term), using various entities in the consolidated group. Paragraph 22a of FASB Statement No. 95, *Statement of Cash Flows*, states that cash receipts from the sales of goods or services are operating cash flows. Paragraph 22a clarifies that classification as an operating activity is required regardless of whether those cash flows stem from the collection of the receivable from the customer or the sale of the customer receivable to others; regardless of whether those receivables are on account or stem from the issuance of a note; and regardless of whether they are collected in the short-term or the long-term. It is important to note that FASB Statement No. 102, *Statement of Cash Flows – Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale* ("SFAS 102"), did not change this requirement. SFAS 102 addressed in part whether loans made by financial and similar institutions were sufficiently similar to product inventory of non-financial institutions such that the cash flow effects of those loans should be classified in the statements of cash flows in the same way as the cash flow effects from the sale of inventory, as operating activities. SFAS 102 did not alter the requirement in paragraph 22a of SFAS 95 to classify cash receipts from the sale of inventory as operating activities. As the SFAS 95 basis for conclusions indicates in paragraphs 93 to 96, the FASB considered and rejected classifying any portion of the cash receipts from the sale of inventory as investing activities.

Presenting cash flows between a registrant and its consolidated subsidiaries as an investing cash outflow and an operating cash inflow when there has not been a cash inflow to the registrant on a consolidated basis from the sale of inventory is not in accordance with GAAP. Similarly, presenting cash receipts from receivables generated by the sale of inventory as investing activities in the registrant's consolidated statements of cash flows is not in accordance with GAAP.

Registrants should ensure that footnote disclosure identifies where the cash flows related to the sale of inventory are classified in the consolidated statements of cash flows and explains the nature of the receivables/notes/loans and where the cash flows from these transactions are classified in the consolidated statements of cash flows. Registrants should also ensure that the line item descriptors on the consolidated statements of cash flows are consistent with those on the consolidated balance sheets and in the financial statement footnotes detailing the components of finance receivables.

2. Classification of Payments Related to Settlement of Pension Liabilities

SFAS 95 states that cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income. Paragraph 23(b) of SFAS 95 states that operating cash outflows includes cash payments made to other suppliers and employees for other goods and services. Contributions to pension plans are reported as operating cash outflows because they relate to employee compensation, an item reported as an expense in the income statement.

Registrants that reorganize in bankruptcy often enter into agreements with the Pension Benefit Guaranty Corporation (PBGC) regarding their liability under employee benefit plans that provide for a settlement of the plan liability through an assumption by the PBGC. The PBGC is a non-profit federally-created corporation that guarantees payment to plan participants of certain pension benefits under defined benefit plans should the plan sponsor be unable to fulfill its obligation. The agreements with the PBGC typically require that payments be made by the registrant at, and/or subsequent to, emergence from bankruptcy for the defined benefit plans that were assumed by the PBGC.

Despite the fact that payments made to the PBGC pursuant to these agreements may continue for several years, the cash outflows should not be classified as financing activities in the statement of cash flows. The form of settlement of the pension liability does not change the substance of the activity for which cash is being paid to any other classification than as an operating activity. In addition, the classification of these payments as an operating activity does not change in the event the registrant is required to apply "fresh start reporting" pursuant to AICPA Statement of Position 90-7, *Financial Reporting by Entities in Reorganization under the Bankruptcy Code,* upon emergence from bankruptcy.

D. Oil and Gas

Staff reviews have uncovered diversity in practice among registrants in the oil and gas industry in several areas. Diversity has been noted in the areas of buy/sell transactions and capitalization of exploratory drilling costs. The accounting for these items is currently being considered by the accounting standard setters. The staff issued letters to registrants in the oil and gas industry in February 2005 requesting additional disclosure in order to provide investors with comparable information in light of the different practices in these areas. See the letter at http://www.sec.gov/divisions/corpfin/guidance/oilgas021105.htm. A brief description of the buy/sell transactions can be found in section II.F.1. of this outline, as the issue may have application outside the oil and gas industry.

The 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

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

In February 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 that should also consider the guidance. An example of the letter is posted on the Commission's website at http://www.sec.gov/divisions/corpfin/guidance/oilgas021105.htm.

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.

The Emerging Issues Task Force (EITF) of the Financial Accounting Standards Board (FASB) is currently considering the issue as to whether some or all of these buy/sell arrangements should be accounted for at historical cost pursuant to the guidance in paragraph 21(a) of Accounting Principles Board Opinion No. 29, *Accounting for Nonmonetary Transactions*. Additionally, we have questions regarding the appropriateness of reporting the proceeds and costs of buy/sell arrangements on a gross basis in the statement of operations. Although consideration of these issues is not yet complete, it is apparent that proceeds and costs associated with such transactions are fundamentally different in character than those of a registrant's primary operations.

Registrants who engage in buy/sell transactions should provide the disclosure requested in the sample letter posted on the Commission's website. Registrants should also consider the guidance in the letter when filing a registration statement under the Securities Act prior to including the requested disclosure in their annual report.

2. Service Contracts and the use of EITF 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
  - Relative fair value or residual method?
  - 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 7 of Accounting Principles Board Opinion No. 20, *Accounting Changes*, 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

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*.

The EITF recently issued No. 03-01, *Other-Than-Temporary Impairments*, which is similar to the staff's historical analysis discussed above. Issue 03-01 requires disclosures addressing impairments in a qualitative and quantitative manner. The consensus requires the securities to be segregated by SFAS 115 classifications and also by length of decline – those with declines of less than a year and those in excess of a year. Remember that SAB Topic 5:M states that management should perform this analysis "[a]cting upon the premise that a write-down may be required." Registrants should not infer that securities with declines of less than one year are not other-than-temporarily impaired, nor should they infer that those declines of greater than a year are automatically impaired. Rather, an other-than-temporary decline could occur within a very short period or, if the facts and circumstances support it, a decline in excess of a year might still be temporary.

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 of 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 registrant's financial performance (including such factors as earnings trends, dividend payments, asset quality, and specific events), the near term prospects of the registrant, the financial condition and prospects of the registrant'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 and Loss Reserves

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.

Income tax contingencies also fall within the scope of SFAS 5. 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.

J. Pension, Post Retirement, and Post Employment Plans (Updated)

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

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.

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 (Updated)

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 (including Form S-8) 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.

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. Financial Statement Presentation and Disclosure

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.

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.

3. 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. 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.

O. 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 (Updated)

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.

P. 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 (New)

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.

Q. 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.

R. 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 (New)

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:

- *Frequently Requested Accounting and Financial Reporting Interpretations and Guidance* - www.sec.gov/divisions/corpfin/guidance/cfactfaq.htm
- *International Financial Reporting and Disclosure Issues in the Division of Corporation Finance* - http://www.sec.gov/divisions/corpfin/internatl/cfirdissues1104.htm

B. Corporation Finance Staffing and Phone Numbers (Updated)

The Division's organizational structure follows:

Division Director – Alan Beller (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 – Consuelo Hitchcock (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 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
Stephanie Hunsaker, Associate Chief Accountant (202) 551-3400
Liaison to: Office # 1 (Health Care and Insurance)
Office # 10 (Electronics and Machinery)
Joel Levine, Associate Chief Accountant (202) 551-3400
Liaison to: Office # 2 (Consumer Products)
Office # 3 (Computers and On Line Services)
Rachel Mincin, Associate Chief Accountant (202) 551-3400
Liaison to: Office # 7 (Financial 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)
Office # 11 (Telecommunications)

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
Kevin Woody
#2 Consumer Products – (202) 551-3720
AD - H. Christopher Owings SACA - Jim Allegretto
Accounting Branch Chiefs: Will Choi
Michael Moran
George Ohsiek
#3 Computers and OnLine Services – (202) 551-3730
AD - Barbara Jacobs SACA - Craig Wilson
Accounting Branch Chiefs: Kathy Collins
Stephen Krikorian
Brad Skinner
#4 Natural Resources and Food – (202) 551-3740
AD - Roger Schwall SACA - Barry Stem
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
	Nili Shah

#7 Financial Services – (202) 551-3770

AD - Todd Schiffman	SACA - Don Walker
Accounting Branch Chiefs:	John Nolan
	Joyce Sweeney
	Kevin Vaughn

#8 Real Estate and Business Services – (202) 3780

AD - Karen Garnett	SACA - Linda Van Doorn
Accounting Branch Chiefs:	Dan Gordon
	Steve Jacobs
	Cicely Luckey

#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

AD - Peggy Fisher	SACA - Martin James
Accounting Branch Chiefs:	Brian Cascio
	Angela Crane
	Michelle Golke

#11 Telecommunications – (202) 551-3810

AD - Larry Spirgel	SACA - Carlos Pacho
Accounting Branch Chiefs:	Terry French
	Bob Littlepage
	Kyle Moffatt

C. Division Employment Opportunities for Accountants

For more information about any of the positions or programs described below, contact Charlee Marcus, 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 a number of new rules the Commission recently adopted 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 through noaction letters.

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 $164,732), plus benefits and relocation expenses. [Note: The salary cap does *not* mean that an academic fellow's maximum 12-month salary is $164,732. Rather, $164,732 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 (Mark Taylor taylorm@sec.gov (audit); Teri Yohn - yohnt@sec.gov (accounting); Cheryl Linthicum - linthicumc@sec.gov (international accounting)), the Division of Corporation Finance (Andy McLelland - mclellanda@sec.gov), or Office of Economic Analysis (Bjorn Jorgensen - jorgensenb@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 2006 -2007 academic fellowships will begin in late 2005, 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 2006.

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.)