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## 2003 AICPA National Conference on Current SEC Developments Compendium of Significant Accounting and Reporting Issues

Representatives of the SEC staff addressed accounting and reporting issues pertaining to the following topics at the AICPA National Conference on Current SEC Developments (December 10-12, 2003 in Washington, D.C.). Representatives of the Public Company Accounting Oversight Board (“PCAOB”) also shared their views on a variety of matters during the conference.

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## **Remarks of Senior SEC Staff**

### **Chief Accountant**

SEC Chief Accountant Donald Nicolaisen addressed the critical role of the audit committee in improving the quality of financial reporting by strengthening their oversight of both the external auditor and management. Nicolaisen stated that there should be “open lines of active, substantive, and brutally honest communication” between the audit committee and the independent auditor. He added, “the audit committee should be the external auditor’s biggest fan and harshest taskmaster.” Nicolaisen also discussed the importance of the “ability of the audit committee to assist management in establishing the proper tone at the top.” He observed that audit committees require more information than before from management in order to understand the company’s financial results and fulfill their responsibilities (e.g., financial and non-financial key performance indicators; material information necessary to understand the company’s financial position, liquidity, capital resources, results of operations and cash flows; trends and uncertainties reasonably likely to have a material effect on the company).

Nicolaisen stated that he favored “a reordering of the GAAP hierarchy to put concepts at the top, followed by objectives and principles, supported by detailed guidance or rules.” He added, “to the extent possible, those standards should avoid unnecessary complexity.” Nicolaisen solicited suggestions for improvements in the current accounting model, such as the use of “additional performance measures, technology solutions, broader disclosures, additional statements, or investor education.”

Nicolaisen called upon participants in the financial reporting process to embrace the recent “radical and necessary changes” in order to further the interests of the profession and the investing public. He concluded, “we have an obligation to the next generation of CPAs to leave behind a legacy of integrity, quality, professionalism, and an ever-improving financial reporting model.”

## **Remarks of Senior PCAOB Staff**

### **Chairman**

PCAOB Chairman William McDonough stated his view that the PCAOB’s objective is to “help auditors find a new direction that will lead to the restoration of public confidence in auditing and in our markets.” He added “accountability-not just to investors, but to the public at large-is what we must be about.”

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In discussing the Board's development of auditing standards, McDonough noted that "for the first time, the people developing standards will have had access to robust, empirical and anecdotal evidence" from the Board's inspections of a cross-section of audits and firms, to assist in setting priorities and developing new auditing standards.

In discussing the Board's inspections of registered public accounting firms, as well as its investigations of potential violations of the Sarbanes-Oxley Act of 2002 (the "Act"), securities laws, or the Board's auditing and related professional standards, McDonough noted, "while our sanctioning authority extends only to registered firms and auditors, we will make referrals to government agencies, most commonly the SEC, when we find potential violations of law or applicable rules by others." He added, "we will also coordinate our investigations with SEC investigations as needed."

**Director, Registration and Inspections**

George Diacont, Director of Registration and Inspections for the PCAOB, noted that engaging in a direct dialogue with the audit committee chair of the issuer was a particularly successful element of the Board's limited inspections in 2003 of the Big Four accounting firms. The purpose of this dialogue, conducted by the more senior PCAOB staff members, was to determine the effectiveness, and the degree of candor, of communications between the accounting firm and the audit committee.

Diacont reported that the other areas of emphasis in the 2003 limited inspections included the firm's audit quality review program, the "tone at the top" regarding the firm's values and emphasis on audit quality, partner compensation practices, and communications between successor and predecessor auditors in connection with auditor changes. Diacont noted that the PCAOB is developing a risk analysis methodology as an aspect of the selection of audit engagements for the PCAOB staff's 2004 inspections. The risk assessment methodology also will help determine whether issues identified by the PCAOB staff are isolated occurrences or suggest a systemic problem, requiring additional procedures. Diacont expects the emphasis of the PCAOB staff's 2004 inspections will be the compliance of audit engagements with GAAP and the Board's auditing standards, including the implementation of Statement of Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit*, and the sufficiency of audit workpaper documentation, particularly relating to the auditor's critical audit procedures and judgments. Diacont also expects the 2004 inspections to focus on the firm's risk assessments, including client acceptance and continuance procedures, tax shelters and their effect on the financial statements, and specific audit engagements subject to litigation.

If the PCAOB staff becomes aware of a possible error in the issuer's financial statements during the inspection of a registered accounting firm, Diacont indicated that the PCAOB would expect the accounting firm to (1) report the matter to the issuer and (2) attempt to resolve the matter in

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accordance with the Board's auditing standards. In addition, Diacont said that if the accounting firm's workpapers do not provide sufficient information to resolve concerns about a potential error, the PCAOB staff may request the Board to issue a request for additional documentation directly from the issuer. Finally, if an error in the issuer's financial statements were discovered during the inspection process, the PCAOB staff would report the matter to the Board, which would decide whether to refer the matter to the SEC.

### **Chief Auditor and Director of Professional Standards**

Dr. Douglas Carmichael, Chief Auditor and Director of Professional Standards for the PCAOB, stressed the importance of restoring auditor professionalism. Specifically, Carmichael noted that auditors should follow the spirit of the auditing standards and ensure that the detection of fraud is an important objective of the audit. Carmichael also expects auditors to design procedures to identify and evaluate the economic substance of related party transactions, challenge the appropriateness of, and assumptions used in, financial models used to determine the fair value of financial instruments, and adhere to Independence Standards Board Standard No. 1, *Independence Discussions with Audit Committees*, by discussing with the audit committee all matters that may reasonably be thought to bear on independence, whether in fact or in appearance.

## **SEC Reporting and Disclosure**

### **MD&A**

#### *Overall Observations*

MD&A continues to be an area of critical focus of the SEC staff. The SEC staff is encouraging companies to critically re-evaluate the quality and focus of their MD&A disclosures in the upcoming reporting season. Specifically, the SEC staff reminded companies that the three principle objectives of MD&A are:

- ❑ To help investors see the company through the eyes of management;
- ❑ To enhance overall financial disclosure and provide the context for analysis; and
- ❑ To provide information so investors can ascertain the likelihood that past performance is indicative of future performance.

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In order to improve the quality of the MD&A disclosures, the SEC staff believes that companies should:

- ❑ Ensure substantive executive level participation in identifying the relevant factors impacting the underlying economics of the business;
- ❑ Emphasize material information, both financial and non-financial, and exclude immaterial information;
- ❑ Describe not only what happened during the periods but also provide the analysis why it happened; and
- ❑ Provide both a historical and forward-looking perspective on past performance and whether known information suggests it will be indicative of future results.

In addition, the SEC staff expects more insightful analysis with respect to liquidity and capital resources. The SEC staff noted that many companies do not sufficiently describe their specific sources and uses of cash. The SEC staff expects companies to clearly describe the underlying drivers of cashflow (e.g., cash received from the sale of goods and services, cash payments to acquire materials) and how any known trends, events or uncertainties are expected to affect those drivers. For example, the SEC staff believes that companies should discuss their reliance on the various sources of cash inflows and how the timing of those cash inflows will correlate to the cash outflows that are required to be presented in the table of contractual obligations under FR-67, *Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations*.

The SEC staff reported that the release of additional MD&A interpretive guidance is under active consideration. As an interpretation of existing SEC MD&A rules, such a release would be effective immediately upon issuance. Specifically, the SEC staff indicated that the release might provide guidance on the following additional matters:

- ❑ Introductory or executive summary, where useful, to provide the context of MD&A;
- ❑ Use of plain English, fewer words and less boilerplate;
- ❑ Use of tabular presentations;
- ❑ Identification of risks; and
- ❑ Discussion of important estimates.

### *Critical Accounting Policies*

The SEC staff indicated that, currently, they do not expect the SEC to issue a final rule regarding the MD&A discussion of critical accounting policies, estimates and related assumptions. Instead, the SEC staff intends to evaluate the continued evolution of disclosures in 2003 annual reports under FR-60, *Cautionary Advice Regarding Disclosure About Critical Accounting Policies*, and then determine whether or not to recommend SEC action on its proposed rule. The

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SEC staff emphasized that companies should specifically evaluate the need for better MD&A disclosure about critical accounting estimates related to loss contingencies, restructuring charges and impairment charges so that investors will have sufficient context to analyze any associated implications to expected future cash flows.

*Tabular Disclosure of Contractual Obligations*

The SEC staff discussed certain issues associated with the initial implementation of FR-67, which requires companies (other than small business issuers, issuers of asset-backed securities and registered investment companies) to include a tabular presentation in MD&A of known contractual obligations as of the end of the most recent fiscal year. This new disclosure requirement must be provided in MD&A for annual financial statements of fiscal years ending on or after December 15, 2003 and must be updated thereafter for any material changes during subsequent interim periods. Specifically, the SEC staff addressed (1) the definition of purchase obligations and (2) whether pension and OPEB obligations fall within the scope of FR-67.

Companies have expressed concern to the SEC staff that FR-67 provides an expansive definition of purchase obligations that, for many large companies, can be difficult and costly to accumulate and aggregate. The SEC staff believes that companies must undertake reasonable efforts and expense to identify and aggregate outstanding purchase obligations. However, if after making these efforts, companies are still unable to fully disclose the amounts of outstanding purchase obligations, companies must (1) assess whether the inability to aggregate this information represents an internal control deficiency (which the SEC staff would not necessarily presume), (2) disclose in a footnote to the table the nature and extent of information that has been excluded and the reason why it has been excluded, and (3) consider disclosing additional information about the significance of the omitted information (e.g., if open purchase orders executed in the normal course of business cannot be aggregated, the SEC staff would expect companies to disclose information such as the amount of historical open purchase orders, the amount of forecasted open purchase orders, the materiality threshold by which the company excluded open purchase orders, or the maximum dollar amount employees are authorized to spend).

The SEC staff believes that the treatment of pension and OPEB obligations in the table requires judgment, but if a company has a material funding obligation, then that amount should be reflected in the table. Ultimately, the SEC staff expects companies to use their best judgment in evaluating whether an item should be disclosed in the table and encourages companies to supplement the table with footnotes disclosing any assumptions or other pertinent data to the extent necessary to understand the timing and amount of the specified contractual obligations, whether included in or excluded from the table.

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### **Internal Control Over Financial Reporting**

The SEC staff discussed their views on a number of implementation questions regarding reporting on internal control over financial reporting under Section 404 of the Act. The SEC staff made the following observations:

- ❑ Management's documentation and testing would likely be more extensive than that of the external auditor (management is required to make more judgments throughout the process and therefore would likely have more documentation);
- ❑ Management has a number of options regarding who can perform management's testing of the operating effectiveness of controls, including internal audit, other company personnel, or external resources (but in each case it is important for management to assess the competence and objectivity of those performing the testing);
- ❑ Inquiry alone does not provide adequate evidence as to the operating effectiveness of internal controls;
- ❑ Most companies will likely follow the COSO framework of internal control, although the SEC rule does not require a specific framework;
- ❑ The scope of the report on internal control is not required to encompass compliance with laws and regulations, only internal control over financial reporting; and
- ❑ SEC periodic reports now require disclosure of any material changes in internal control over financial reporting and only an active evaluation of the effectiveness of disclosure controls and procedures by management would be able to identify such changes (a passive process to evaluate the effectiveness of disclosure controls and procedures, such as one consisting primarily of ongoing negative assurance provided within the company, would not likely be adequate to identify material changes requiring disclosure).

### **Discontinued Operations**

#### *Registration and Proxy Statements*

When a company must restate its prior period financial statements for discontinued operations, in conjunction with filing a registration statement or proxy statement, the SEC staff affirmed that companies can either include the restated financial statements in the registration statement or proxy statement or file restated financial statements under Item 5 of Form 8-K and incorporate the Form 8-K by reference into the registration statement or proxy statement. However, the SEC staff emphasized that companies should not amend their previously filed Form 10-K to report discontinued operations because at the time the Form 10-K was filed, the financial statements complied with generally accepted accounting principles. Regardless of the alternative elected, the SEC staff believes that the restated financial statements should be accompanied by a "revised MD&A." The "revised MD&A" should, at a minimum, discuss the events or circumstances that led to the discontinued operation, the material terms of the transaction, and the impact on the

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company's operating results and business. While such "revised MD&A" could supplement MD&A originally filed in the most recent SEC annual report, companies may elect to provide MD&A fully updated to address the company's continuing operations.

The SEC staff also reminded companies that restated financial statements for discontinued operations are not permitted under FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, until the financial statements have been issued for the period in which the discontinued operation was required to be recognized due to its disposition or classification as held for sale. Therefore, until financial statements reporting the discontinued operation are filed, under Article 11 of Regulation S-X, a registration statement or a proxy statement should include pro forma financial information giving effect to a discontinued operation that is significant (i.e., at the 10% level based on any of the significance tests in Regulation S-X Rule 1-02(w)). The SEC staff emphasized that the pro forma financial statements giving effect to the discontinued operation should include income statements for all periods presented as well as a balance sheet as of the date of the most recent historical information presented.

*Regulation S-X Rule 3-05*

Regulation S-X Rule 3-05 addresses the requirements to file separate financial statements of a significant business acquired or that is probable of being acquired. The SEC staff noted that one of the tests to measure significance is the ratio of the acquiree's pretax earnings from continuing operations to the company's pretax earnings from continuing operations based on the most recent annual financial statements filed at or prior to the date of the acquisition. The SEC staff indicated that once a company files restated financial statements for discontinued operations, a company should use the restated financial statements for purposes of determining significance only for (1) probable acquisitions as of the date of the registration statement or proxy statement or (2) businesses acquired after the restated financial statements have been filed. For acquisitions consummated prior to the filing of the restated financial statements, companies should measure significance using the financial statements filed before the acquisition, generally those in the company's previous SEC annual report.

*Regulation S-X Rule 3-09*

Regulation S-X Rule 3-09 addresses the requirement to file separate financial statements for significant equity method investments in SEC filings. The SEC staff noted that the income (pretax earnings from continuing operations) test to measure significance is performed annually at year-end. The SEC staff indicated that when a registration statement or a proxy statement includes or incorporates by reference restated financial statements for discontinued operations, a company should *not* use the restated financial statements for the purposes of determining significance. The SEC staff noted that companies should use the financial statements filed in

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connection with the next Form 10-K to determine the associated requirements of Rule 3-09 in that annual report. It should be noted, however, that as a result of discontinued operations, a previously insignificant equity method investment could become significant to an earlier year.

**Preferability Letter - Change in the Date of the Annual Goodwill Impairment Assessment**

Paragraph 26 of FASB Statement No. 142, *Goodwill and Other Intangible Assets*, requires the annual assessment of goodwill impairment to be performed as of the same date each year for the respective reporting units. As previously indicated in the minutes of the March 11, 2003 joint meeting with the AICPA SEC Regulations Committee, the SEC staff believes that when the balance of goodwill is material, a change in the annual date for testing a reporting unit's goodwill for impairment would represent an accounting change that would require a preferability letter from the company's auditors regardless of the materiality of the effect of the change.

**Reconciliation to US GAAP**

Deputy Chief Accountant Scott Taub addressed the importance of international convergence in "accounting, auditing, and disclosures" for the benefit of investors and facilitating companies' access to the capital markets. As a result of a European Union ("EU") mandate, companies located in a member EU state must adopt International Financial Reporting Standards ("IFRS") in 2005. Taub observed that less than 50 registrants currently use IFRS to prepare their primary financial statements filed with the SEC, with the required reconciliation to US GAAP. As European companies adopt IFRS in 2005, Taub expects that their US GAAP reconciliations will provide the SEC staff with valuable information regarding the progress and remaining challenges of convergence. As to when the SEC would accept IFRS financial statements without reconciliation to US GAAP, Taub stated that it would depend, in part, on whether the IASB continues to be a strong independent standard-setter. Taub predicted that the SEC "will at some point" eliminate the reconciliation of IFRS to US GAAP but did not predict when this may happen.

**Trust Preferred Securities**

The SEC staff indicated that FASB Interpretation No. 46, *Consolidation of Variable Interest Entities, an interpretation of ARB No. 51, Consolidated Financial Statements*, may require the deconsolidation of a trust that has issued trust preferred securities. The SEC staff expressed the view that if the company is required to deconsolidate a trust that has issued trust preferred securities, the company may still avail itself of the relief provided under Rule 3-10(b) of Regulation S-X and provide the same disclosures as would otherwise be required, as long as the trust qualifies as a finance subsidiary under Rule 3-10 and the company provides additional disclosure regarding the deconsolidation of the trust and the related impact on the financial statements. In addition, the SEC staff would not require the trust issuer to provide separate

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financial statements, by reference to Exchange Act Rule 12h-5, notwithstanding the fact that the trust is no longer consolidated by the company.

## **Accounting and Disclosure**

### **Revenue Recognition**

#### *Issues Related to EITF 00-21*

The SEC staff discussed the implications of EITF Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*, when software contracts within the scope of Statement of Position (“SOP”) No. 97-2, *Software Revenue Recognition*, involve significant production, modification or customization of the software, as well as “non-construction-related activities.” Prior to the implementation of EITF 00-21, some interpreted SOP 97-2 to require the entire arrangement, including the “non-construction related activities,” to be accounted for under SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*. The SEC staff indicated that, for arrangements entered into in fiscal periods (annual or interim) beginning after June 15, 2003, paragraph 4 of EITF 00-21 now requires the company to evaluate whether the “construction-related activities” within the scope of SOP 81-1 should be separated from “non-construction activities” that are outside the scope of SOP 81-1 (e.g., ongoing software maintenance services).

The SEC staff reminded companies that footnote 3 to paragraph 4 of EITF 00-21 requires leased assets within arrangements with multiple deliverables to be accounted for separately under FASB Statement No.13, *Accounting for Leases*, regardless of whether the leased assets meet the separation criteria under EITF 00-21. For example, when leased as part of a software arrangement, including a customized build-to-suit software system, hardware or equipment and any related executory costs are required to be accounted for separately under FAS 13.

The SEC staff also discussed the implications of paragraph 14 of EITF 00-21, which limits the amount of revenue that can be allocated to a separate delivered element to the amount of non-contingent consideration. In some cases, this may result in the allocation of little or no revenue to a delivered element. The SEC staff emphasized that even though a loss may be incurred on a delivered element as a result of contingent consideration, the separation criteria in EITF 00-21 are not elective, and items meeting the separation criteria under EITF 00-21 may not be combined or accounted for as a single unit of accounting. The SEC staff acknowledged that this view is in conflict with Staff Accounting Bulletin (“SAB”) No. 101, *Revenue Recognition in Financial Statements*, which allows an election to defer revenue recognition until installation is completed. The SEC staff has resolved this inconsistency through the issuance of SAB No. 104, *Revenue Recognition*.

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*Costs Incurred Related to Revenue Contracts that Provide for Contingent Revenue*

Historically, in the SEC staff's view, the capitalization of costs associated with a specific revenue contract generally has been limited to the amount of deferred revenue recorded, as discussed in SAB 101, except in limited situations where, at a minimum, an enforceable contractual arrangement exists assuring recovery. In situations where little or no revenue is allocated to a delivered element as a result of contingent consideration, the SEC staff observed that deferred revenue should not be recognized for the difference between the cash received (or amounts billed) and the relative fair value of the delivered item. However, in the SEC staff's view, in these circumstances it may be appropriate to record an asset, such as an investment in the remainder of the contract, to the extent of the loss recognized on the delivered element. Such an asset should be subject to impairment testing based on the estimated net cash flows to be received for future deliverables under the arrangement. The SEC staff cautioned that it would object to the deferral of costs merely to produce a normal profit on delivered elements.

*Accounting for Service Contracts*

The SEC staff emphasized that service contracts, which are generally outside the scope of SOP 81-1, may be accounted for using the proportionate performance method of revenue recognition in certain circumstances. The SEC staff generally would expect a company to look to output measures (such as contractual milestones) as the basis for revenue recognition. The SEC staff would object to revenue recognition on the basis of input measures (such as labor hours) unless the input measures are a reasonable surrogate for contractual performance.

**Accounts Payable Financing Arrangements**

The SEC staff reminded companies that Rule 5-02.19 of Regulation S-X requires that various components of accounts and notes payable be separately disclosed on the face of the balance sheet. Further, the SEC staff reminded companies that where trade accounts payable to a vendor are essentially converted to borrowings from a lender, FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, requires the company to de-recognize the trade accounts payable and record a separate liability, which should be classified on the balance sheet as a borrowing from a lender. Consistent with this classification, the SEC staff expects the company to accrete the difference between the initial carrying amount of the borrowing and the repayment amount through interest expense using the effective interest method.

The SEC staff provided an example involving the use of a structured arrangement whereby a lender (e.g., a bank or lending institution) makes payment on behalf of the company to a company's trade creditor in exchange for a note or promise to pay from the company. This payment sometimes occurs before the contractual due date of the trade payable in order to take

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advantage of an available discount for early payment. The company subsequently repays the lender at a later date. In another variation of the same transaction, the vendor may participate along with the company in the arrangement with the lender. Specifically, the vendor agrees to receive payment from the lender on behalf of the company, creating an obligation for the company to later repay the lender. The lender may further provide the vendor with the ability to receive accelerated payment at a discounted amount. The SEC staff believes that the substance of these transactions equates to the company obtaining financing from the lender in order to pay amounts due to its vendor and, pursuant to FAS 140, the company's trade accounts payable to the vendor is extinguished on the date the lender remits cash or a lender note to the vendor.

### **Contingent Income Tax Benefits**

The SEC staff observed that while FASB Statement No. 109, *Accounting for Income Taxes*, provides guidance on the establishment of a valuation allowance related to the realizability of deferred tax assets, little guidance is provided on the recognition of contingent tax benefits associated with tax advantaged transactions. In the SEC staff's view, contingent tax benefits should be evaluated for initial recognition like any other contingent assets, that is, based on probability. In the period in which a company concludes that it is probable a tax deduction will be sustained, it should recognize a deferred tax asset with respect to that contingent tax benefit. The deferred tax asset then would be evaluated under FAS 109 and a valuation allowance would be established sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized. In these circumstances, the evaluation of the need for a valuation allowance would not be affected by an evaluation of the sustainability of the deduction because the company would have already concluded that the sustainability of the deduction was probable in order to record the deferred tax asset. Instead, the evaluation should be limited to the likelihood of realization based on reversals of existing taxable temporary differences, taxable income and tax planning strategies.

The SEC staff observed that some companies measure temporary tax differences by comparing the financial reporting basis with the probable tax basis. The SEC staff reminded those companies of the need to recognize a contingent tax liability to the extent of tax benefits received for the difference between the "probable" tax basis and the "as-filed" tax basis as contemplated in Question 17 of the FASB Staff Implementation Guide to FAS 109. The SEC staff emphasized that such a contingent tax liability, like other tax contingencies, should not be classified within deferred tax liabilities or as part of any deferred tax asset valuation allowance. On the other hand, the SEC staff observed that other companies measure temporary tax differences by comparing the "financial reporting" basis with the "as-filed" basis. For those companies, the associated contingent tax liability would be considered implicitly in the deferred tax liability. The SEC staff reminded companies that apply this practice of the need to provide consistent disclosure of the components of deferred tax liabilities from period to period.

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**Asset Retirement Obligations in Leases**

Certain lease agreements require the lessee to return the leased property to its original condition at the end of the lease term or perform some other asset retirement activity. The SEC staff noted that some companies have accounted for this obligation within the scope of FAS 13, while other companies have accounted for this obligation within the scope of FASB Statement No. 143, *Accounting for Asset Retirement Obligations*. The SEC staff has not objected to either accounting treatment as long as it is consistently applied. If the retirement obligation is accounted for in accordance with FAS 13, the SEC staff believes that the obligation is not attributable to contingent events such as damage, extraordinary wear and tear, excessive usage or the passage of time. Thus, the SEC staff believes that the retirement obligation should not be treated as contingent rent, instead the SEC staff would expect the lessee, in an operating lease, to accrue the estimated settlement costs over the lease term and, in a capital lease, to include the estimated settlement costs as part of the minimum lease payments.

If the retirement obligation is accounted for in accordance with FAS 143, some companies have argued based on paragraph A16 in FAS 143 that insufficient information exists to estimate the fair value of the asset retirement obligation. Specifically, companies have argued that they cannot reliably estimate both the range of settlement dates and the probability that the lessor will require the lessee to undertake the asset retirement obligation. The SEC staff has objected to the assertion that a range of settlement dates cannot be reliably estimated. The SEC staff, however, acknowledged that there may be more than one acceptable approach to determining the range of settlement dates and has not objected to various analyses (e.g., some companies may include expected renewals while other companies may not).

FAS 143 requires recognition of a conditional asset retirement obligation before the event that either requires or waives performance occurs. For example, if a lessor retains a right (an option) to decide whether to require a lessee to perform a retirement activity associated with the leased asset, the lessee must record an asset retirement obligation. The uncertainty surrounding the conditional performance of the retirement obligation must be factored into the measurement of the obligation through an assessment of the likelihood that performance will be required. In making that assessment, the SEC staff believes that companies must consider all available evidence including evidence that may or may not be company specific or industry specific. Paragraph A23 of FAS 143 provides guidance that, in situations in which the conditional aspect has only 2 outcomes and there is no information about which outcome is more probable, a 50 percent likelihood for each outcome should be used in the measurement of the obligation until additional information becomes available. Thus, the SEC staff observed that in a situation where the lessor has the option to require the lessee to undertake the asset retirement obligation, absent any other information as to which outcome is more likely, the initial measurement of the obligation by the lessee should be based on a 50 percent probability of option exercise. On the other hand, if the lessee has an unambiguous obligation to perform the asset retirement

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obligation, the SEC staff believes that the unambiguous obligation inherently provides guidance about which outcome is more likely. In these circumstances, the SEC staff noted that paragraph A18 of FAS 143 suggests that evidence of past history of non-enforcement must be present in order for the measurement of the obligation to be affected by any uncertainty over the requirement to perform the retirement activities. Absent such evidence, the SEC staff believes that the initial measurement of the asset retirement obligation should assume that performance would be required.

### **Earnings per Share**

EITF Issue No. 90-19, *Convertible Bonds with Issuer Option to Settle for Cash upon Conversion*, addresses the earnings per share (“EPS”) impact of a convertible instrument (Instrument C in the consensus) whereby upon conversion, the company must settle the face value and interest in cash but the conversion spread (the excess of the conversion value over the face value) could be satisfied in either cash or stock. The EITF concluded that the if-converted method was not appropriate and the company should increase the diluted EPS denominator by the variable number of shares that are presumed will be issued upon conversion unless the company has a stated policy or past practice of cash settling these obligations. The SEC staff noted situations where companies are applying the accounting treatment afforded to Instrument C to hybrid instruments that do not meet the definition of Instrument B in EITF 90-19. Specifically, the SEC staff noted that companies believe that by combining the hybrid instrument’s settlement flexibility (cash or share settle) with a stated policy of cash settling the bond’s principal amount, the company is entitled to the accounting treatment under Instrument C while giving the company the flexibility to share settle if it becomes prudent to do so. The SEC staff emphasized that, in its view, the mere assertion of a cash settlement policy is not sufficient to overcome the presumption of share settlement. The SEC staff indicated that a company’s stated policy must have substance and highlighted the following factors to consider:

- ❑ The extent to which the flexibility associated with the ability to share settle factored into senior management’s decision to approve the issuance of the instrument, rather than an instrument that only allowed for cash settlement;
- ❑ The company’s positive intent and ability to cash settle the face value and the interest component of the instrument upon conversion (both current and future liquidity should be considered in determining whether positive intent exists);
- ❑ Management representations attesting to the company’s positive intent and ability to cash settle;
- ❑ Disclosures in the current period financial statements and in the offering document that support the company’s positive intent to adhere to the stated policy; and
- ❑ Whether the company has previously share settled contracts that provided the company with a choice of settlement alternatives.

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The SEC staff emphasized that principal executive officers and principal financial officers should evaluate the substance of any accounting policy that depends upon management's intent including the EPS treatment of contracts and instruments that provide for either cash or share settlement at the option of the issuer. The SEC staff believes that the substance of such a policy would bear on the conclusions expressed in the certifications, and related disclosures, required pursuant to Section 302 and Section 906 of the Act. Finally, the SEC staff reminded companies that the FASB's exposure draft in connection with the short-term convergence project would eliminate a company's ability to overcome the presumption of share settlement through a stated policy and past practice. The Exposure Draft was issued on December 15, 2003, and, if finalized as proposed, would be effective for financial statements for both interim and annual periods beginning after December 15, 2003, with retroactive adjustment of prior periods.

### **Cash Flow Statement**

Chief Accountant Donald Nicolaisen encouraged companies to consider using the direct method of preparing the statement of cash flows. Nicolaisen stated that the SEC will not mandate this change but it is an action that companies should consider to "promote transparency given the importance to investors of cash flow information."

### **Business Combinations: Settlement of Litigation Over Purchase Price of Acquired Business**

Paragraph B177 of FASB Statement No. 141, *Business Combinations*, indicates that contingencies arising from an acquisition subsequent to the initial allocation of the purchase price to the underlying assets and liabilities acquired as of the date of acquisition, such as litigation over the purchase price of the acquired company, are the acquiring company's contingencies rather than contingencies of the acquired company, or preacquisition contingencies. Accordingly, the SEC staff generally has concluded that legal claims between the acquiror and the former owners of the acquired business should be reflected in the income statement in the period that the loss contingency becomes probable. The SEC staff indicated that an adjustment of the purchase price would only be appropriate in situations where the acquiror is able to demonstrate a clear and direct link between the legal claim and the determination of the purchase price. For example, litigation seeking enforcement of an escrow arrangement where the purchase agreement specified a minimum level of working capital in the acquired company may establish a clear and direct link to the purchase price. In circumstances where such an adjustment of the purchase price is appropriate, the SEC staff would expect the adjustment to be recognized consistently with the initial purchase price allocation and subsequent accounting. The SEC staff cautioned that legal claims also may include general claims unrelated to the purchase price, for example, alleged misrepresentations or claims that other aspects of the purchase agreement were unclear. The SEC staff indicated that companies should carefully evaluate the underlying legal claim, and any portion of the legal claim not clearly and directly linked to the purchase price should be reflected in the income statement. The SEC staff also

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reminded companies that all costs of claims and litigation brought against the acquiror by its own shareholders should be reported in the income statement and would not effect purchase accounting.

**Consolidation: Subsidiary in Bankruptcy**

Paragraph 2 of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, as amended by FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, and FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, indicates that a majority-owned subsidiary shall not be consolidated if control does not rest with the majority owner, for example, a subsidiary in bankruptcy. The SEC staff indicated that, in certain unique circumstances, continued consolidation of a subsidiary in bankruptcy might be appropriate. In a recent case, the SEC staff noted that it did not object to the continued consolidation of a subsidiary in bankruptcy by a parent company or which was a majority common shareholder, a priority debt holder, and the subsidiary's single largest creditor. In that case, the parent company negotiated a pre-packaged bankruptcy with the subsidiary's other creditors, expected to regain a majority voting control after the bankruptcy, and expected the bankruptcy to be completed in less than one year. The SEC staff emphasized that continued consolidation of a subsidiary in bankruptcy requires a unique set of facts and circumstances and that the SEC staff would expect such instances to be rare. The SEC staff reminded companies that the continued consolidation of a subsidiary in bankruptcy should be reassessed periodically, and adequate disclosure should be provided of the facts and circumstances.

**Consolidation: Substantive Kick-Out Rights**

In a limited partnership arrangement, SOP No. 78-9, *Accounting for Investments in Real Estate Ventures*, indicates that if the limited partners have important rights (e.g., the right to replace the general partner or partners), the partnership may not be under the control of the general partner, which would preclude the general partner from consolidating the partnership. The SEC staff noted that there has been diversity in practice in determining whether such important rights, or "kick-out rights," are deemed substantive. The issue of "kick-out rights" recently has been addressed in a very limited circumstance in FASB Staff Position ("FSP") No. FIN 46-7, *Exclusion of Certain Decision Maker Fees from Paragraph 8(c) of FASB Interpretation No. 46, Consolidation of Variable Interest Entities*. FIN 46-7 concluded that "kick-out rights" are substantive if (1) the decision maker can be removed by the vote of not more than a simple majority of the voting interests held by the parties other than the decision maker and the decision maker's related parties, and (2) the parties holding the kick-out rights have the ability to exercise those rights if they choose to do so, that is, there are no significant barriers to the exercise of the rights. The SEC staff is evaluating whether this guidance should be applied in other consolidation circumstances (e.g., SOP 78-9) and is encouraging companies to consider this guidance when evaluating the accounting for newly created entities.

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**Consolidation: FIN 46**

Chief Accountant Donald Nicolaisen stated that the SEC staff was “disappointed by the seemingly minimal disclosures of many registrants” regarding their interests in variable interest entities and the expected effects of adopting FIN 46. He warned companies that the SEC staff would be reviewing the adoption of FIN 46, including disclosures, very closely in the upcoming reporting season.

**Equity Method Investments**

The SEC staff emphasized that it will continue to question transactions where the form of the arrangement is a structured transaction designed to avoid loss recognition under APB Opinion No. 18, *Equity Method of Accounting for Investments in Common Stock*, while substantively the investor is functioning as a voting common stockholder that significantly influences the investee. In the SEC staff’s view, the determination whether an investor has significant influence over an investee should not be limited to the rights conveyed by voting common stock; rather consideration should be given to all means by which an investor may exercise significant influence over the investee (e.g., board representation, voting rights conveyed by a security other than voting common stock). The SEC staff has concluded in some instances that the investor had significant influence over the investee and held securities that functioned as “in-substance” common stock, regardless of whether those securities had a liquidation preference. In determining whether a company has “in substance” common stock, the SEC staff believes that companies should consider the following factors: (1) the capitalization structure of the investee (e.g., to the extent that no common capital exists or exists only in the form of founder shares, the liquidation preference of preferred stock held by the investor may not be substantive and the preferred stock may be “in substance” common stock), and (2) the characteristics of the security (e.g., where the return to the investor is based on the underlying performance of the investee, the arrangement may be more in the nature of a shareholder relationship than a creditor relationship).

**Reportable Segments**

The SEC staff continues to focus on segment reporting, especially the application of the aggregation criteria in paragraph 17 of FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*. When considering whether the aggregation of operating segments is appropriate, the SEC staff emphasized that companies should first look to the objectives and basic principles of FAS 131. In the SEC staff’s view, the overriding objective and principle of FAS 131 is to provide the users of the financial statements the same information that management receives to assess performance and allocate resources. Then, the company may consider whether aggregation is appropriate by assessing whether the operating segments have similar economic characteristics and meet the five qualitative criteria in paragraph 17 of FAS 131. Assessing the similarity of economic characteristics of operating segments requires

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judgment based on the facts and circumstances, but the SEC staff expects that such an assessment would not be limited to the gross margins of the operating segments. If relevant, the SEC staff expects such an assessment to consider the similarity over the period of other measures that the chief operating decision maker uses to evaluate performance, including, for example, operating profit. The SEC staff also expects such an assessment to evaluate the similarity of segments' long-term financial performance, considering both historical and future results over a sufficient time period. For example, in the SEC staff's view, three years of past, and three years of estimated future financial performance would not be sufficient to determine whether the operating segments have similar economic characteristics.

## **Financial Instruments**

### **Loan Commitments**

The SEC staff emphasized that loan commitments that relate to the origination of mortgage loans that will be held for resale are written options from the perspective of the prospective lender. Such commitments also are commonly known as "interest rate locks" extended to prospective mortgage applicants. Pursuant to Statement 133 Implementation Issue C13, *When a Loan Commitment is Included in the Scope of Statement 133*, and later codified by FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, lenders and originators have been accounting for these loan commitments as derivative instruments in their fiscal quarters beginning after April 10, 2002. However, the SEC noted that there is diversity in practice as to how the fair value of the interest rate lock feature of the loan commitment is determined. Some lenders believe that the initial fair value of the interest rate lock results in an asset due to the inherent intangible customer and servicing rights, whereas other lenders believe that the initial fair value of the interest rate lock is zero. The SEC staff expressed its view that the fair value of the loan commitment derivative should not include the related intangible customer or servicing right, which would be only recognized in the event of a business combination. Therefore, a loan commitment should never have a positive fair value. Thus, upon origination of a loan commitment, the SEC staff believes that the fair value of the loan commitment should be recorded as a liability with the offsetting debit to expense to the extent consideration has not been received. The SEC staff noted that the written option would always remain a liability until expiration or culmination of the contract.

The SEC staff emphasized that this accounting treatment should be applied to all loan commitments originated in the first reporting period beginning after March 15, 2004. Companies could continue to apply their current accounting treatment to any previously recognized loan commitments. The SEC staff noted that companies should disclose this upcoming change in their accounting policies and the anticipated impact of this change in

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accordance with SAB 74 (Topic 11-M), *Disclosure of the Impact that Recently Issued Accounting Standard Will Have on the Financial Statements of the Registrant When Adopted in a Future Period*, in any filings with the Commission that predate the change. The SEC staff expects to issue a staff accounting bulletin to formalize their views on this matter.

### **Hedge Documentation and Effectiveness Testing**

The SEC staff noted that it has recently observed instances of sloppy hedge documentation and aggressive interpretations of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Specifically, the SEC staff noted situations (1) where the method used by the company to assess hedge effectiveness was inconsistent with the method that was defined and documented at the time the company designated the hedge relationship, and (2) where the company had used statistical techniques (e.g., regression analysis) to assess hedge effectiveness without sufficient experience to apply those techniques in an appropriate manner.

With respect to the method defined and documented by the company to assess hedge effectiveness, the SEC staff has observed situations where the company documented that it would use a series of tests to determine whether the hedge relationship was highly effective. If any one of these tests resulted in the hedge being highly effective, the company concluded that hedge accounting was still appropriate. The SEC staff believes that this approach is inconsistent with the guidance in paragraph 62 of FAS 133 and Statement 133 Implementation Issue No. E7, *Hedging-General: Methodologies to Assess Effectiveness of Fair Value and Cash Flow Hedges*. The SEC staff believes that only one method should be used to assess hedge effectiveness. In addition, the SEC staff has observed situations where the documented hedge period did not coincide with the “rebalancing” of the hedge portfolio. The SEC staff would object to a documented hedge period of either monthly or quarterly when the hedge is being “rebalanced” on a daily or weekly basis. The SEC staff believes that the documented hedge period should coincide with the “rebalancing” of the hedge portfolio.

With respect to statistical techniques, the SEC staff noted situations where companies did not fully consider all of the relevant outputs of the regression analysis in assessing whether the hedge was highly effective. The SEC staff believes that, at a minimum, the following outputs should be considered in assessing whether the hedge would be highly effective: (1) R-squared, (2) slope coefficient (beta) and (3) T- or F-statistics. The SEC staff expects companies to be able to appropriately evaluate all of the regression outputs, which may require the use of statistical specialists.

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### **Classification of Economic Hedges and Derivatives**

The SEC staff addressed the income statement classification of “economic hedges” that were not designated hedges under FAS 133. The SEC staff noted that many companies have classified the unrealized gains and losses due to the change in the fair value of the derivative as “risk management activities” within the income statement. The SEC staff, however, believes that the subsequent reclassification of realized gains and losses on those derivatives from “risk management activities” to another income statement line item is inappropriate. The SEC staff believes that economic hedges that did not qualify for hedge accounting under FAS 133 should not be accounted for as if they were designated hedges. In addition, the SEC staff would expect the company to disclose in its financial statements where the change in the fair value of an “economic hedge” is classified. Furthermore, the SEC staff believes that companies should discuss in “plain English” in MD&A the distinction between “economic hedges” and designated accounting hedges.

The SEC staff also addressed splitting elements of a derivative in the income statement. The SEC staff noted that generally it would be inappropriate for the *end user* of a derivative to provide a “split” presentation in the income statement. However, the *writer* of a derivative could support a “split” presentation in the income statement depending on the specific facts and circumstances. If the writer provides a “split” presentation, the SEC staff would expect the writer to disclose in its financial statements its policy and the amounts and classifications of the components of the change in fair value in the income statement, including premiums received, settlements realized in cash and unrealized changes in fair value.

### **DIG B6 and EITF 02-3**

The SEC staff addressed the interaction of Statement 133 Implementation Issue No. B6, *Embedded Derivatives: Allocating the Basis of a Hybrid Instrument to the Host Contract and the Embedded Derivative*, and EITF Issue No. 02-3, “*Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities.*” B6 addresses how an embedded derivative should be bifurcated from the host contract when separate accounting for the embedded derivative is required under FAS 133. In order to determine the initial carrying value of the host contract, the SEC staff indicated that companies should use the “with and without” method based on the fair value of the embedded derivative as described in B6. The SEC staff emphasized that applying this method would preclude any immediate gain or loss recognition. The SEC staff believes that the embedded derivative should be recorded at fair value, which would result in the inclusion of any gain or loss at inception in the value of the host contract, which should be amortized as a yield adjustment over the life of the contract. The SEC staff would object to immediate recognition of a gain or loss upon bifurcation of the embedded derivative even where, if freestanding, under EITF 02-3, a company might recognize dealer profit or an unrealized gain or loss at the inception

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of a contract (e.g., option contract) when fair value is supported by quoted market prices or other current market transactions.

### **FAS 150 and FSP FAS 150-3**

As announced in the November 2003 EITF minutes, the SEC temporarily amended EITF Topic No. D-98, *Redeemable Securities—Classification and Measurement*, upon the issuance of FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, to clarify that once a security is covered by the scope of FAS 150, a company should no longer follow the guidance of Topic D-98. However, the issuance of FSP No. 150-3, *Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*, delayed the implementation of FAS 150 for certain mandatorily redeemable instruments. For example, for minority interests that must be redeemed only upon the liquidation of a limited-life subsidiary, both the classification and measurement guidance of Statement 150 are deferred indefinitely. Therefore, the SEC staff noted that companies with instruments that qualify for deferral under FSP 150-3 should continue to look to Topic D-98 for guidance on classification and measurement, as appropriate, based on the respective element (classification and/or measurement) deferred by FSP 150-3. For example, assume prior to the effective date of FAS 150 a company accounted for mandatorily redeemable preferred shares of a consolidated subsidiary classified as minority interest and reflected changes in that minority interest under one of the methods under Topic D-98. FAS 150 (as temporarily modified) still requires reclassification of that minority interest to a liability, but does not require subsequent adjustments to the carrying value. In this case, a company would continue to follow the measurement guidance under Topic D-98.

On a related note, the SEC staff noted that the deferral provisions under FSP 150-3 do not apply to a broker-dealer that files financial statements with the SEC.

### **Modification of Remarketable Put Bonds**

The recent low interest rate environment has led investment banks and issuers, in some cases, to modify remarketable put bonds as their remarketing dates approach. Such modifications often involve increasing the face value (principal) of the bond and/or decreasing the coupon interest rate in order to adjust to the current interest rate environment. In these scenarios, the SEC staff believes that the investment banks' role in the remarketing has often switched to that of an *agent* rather than a principal, their typical role if the remarketable put bonds were not modified. Accordingly, in situations where the original terms of the bonds did not contemplate either the increase in face amount or decrease in coupon interest rate, the SEC staff believes that the issuer of the bonds must apply EITF Issue No. 96-19, *Debtor's Accounting for a Modification or*

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*Exchange of Debt Instruments.* EITF 96-19 indicates that, when the remarketing transaction involves the intermediary (investment bank) acting as an agent, the original remarketable put bond has been *extinguished* if it has been *substantially modified* and should be accounted for as an extinguishment and issuance of new debt at fair value (i.e., the difference between the old carrying amount of the bonds and the new fair value should be recorded in the income statement). Under EITF 96-19, even if the intermediary is determined to be acting as an agent, if the bonds have *not* been substantially modified, the issuer would simply account for the modification as a change in the effective interest rate to maturity.

### **FIN 45 Guarantees**

The SEC staff reminded companies that guarantees under FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, that meet the scope exception under paragraph 10(d) of FAS 133 are not written options and should only be recognized at fair value at the date of issuance. Thereafter, any change in the contingent liability associated with the underlying guarantee should be measured under FASB Statement No. 5, *Accounting for Contingencies*. That is, the guarantee should not be subsequently marked to market. The SEC staff further indicated that companies should establish a systematic and rational method for amortizing any initial value associated with the guarantee. The SEC staff clarified that reducing the initial fair value to zero on the basis that it was not probable the company had an obligation under FAS 5 would not be appropriate since the inherent fair value associated with the guarantee considered the likelihood that the company would be obligated to perform. The SEC staff believes that the same theory would apply to many recourse obligations under FAS 140 that meet the definition of a guarantee under FIN 45.

### **Scope Exception in EITF 99-20**

The SEC staff noted that paragraph 5(e) of EITF Issue No. 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets*, excludes from the scope of the issue beneficial interests in securitized financial assets that are of a high credit quality (e.g., those guaranteed by the U.S. government, its agencies, or other creditworthy guarantors). In SEC staff's view, securities with a credit rating below AA would not meet this exclusion.