



BDO Seidman, LLP
Accountants and Consultants



Financial Reporting

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Accounting Year In Review: 2004

BDO Seidman, LLP prepared this *Financial Reporting* letter to help our clients anticipate and respond to questions that may arise in connection with financial statements for 2004.

Before it was over, 2004 brought four new FASB statements, including a major revision to the standard on accounting for stock-based compensation. It also brought more consistent reporting of earnings from continuing operations, more precise calculations of earnings per share, and dozens of other technical interpretations and clarifications. But the accounting pronouncements don't tell the full story this year. Most of all, 2004 was a year of promise and improvements made possible by a series of mini-breakthroughs in financial reporting.

The breakthroughs didn't come from individual standards or isolated bits of knowledge. They came from putting together the pieces of the financial reporting puzzle in new and innovative ways. The myriad pieces, events and trends that have shown the way to better reporting this year ranged from new tax laws and reporting requirements on internal controls to tougher enforcement of state laws, a reenergized SEC and continuing technological advances.

Throughout this *Financial Reporting* letter, you will find comments on the breakthroughs and how your company can benefit from them. We hope you will find these suggestions useful in preparing your 2004 financial statements and in the months to come.

Accounting for the American Jobs Creation Act

The Act creates tax incentives to keep jobs in the United States and return funds from abroad. Accounting for these tax benefits requires judgment and may also require additional controls.

Companies with operations in the United States must begin now to account for the effects of the American Jobs Creation Act of 2004. The Act will likely cause changes in companies that go far beyond the tax department. Accounting for the effects of the Act will require judgment, and there is a direct impact on financial reporting for public companies. The Act sets stiffer penalties related to tax shelters, and it requires disclosure of such penalties by public companies in SEC filings.

Below are key questions companies should be prepared to answer.

Is the company accounting properly for the tax effects of its production activities?

Questions might arise about accounting for the effects of the Act's tax incentives for manufacturing companies to keep production activities in the United States.

The Financial Accounting Standards Board (FASB) provided guidance on accounting for the domestic production incentives in FSP FAS 109-1, "Application of FASB Statement No. 109, *Accounting for Income Taxes*, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004."

FSP FAS 109-1 indicates that companies should account for the production incentives as a special deduction rather than as a rate reduction. This means that companies will recognize the tax benefits gradually, year-by-year, not as a large non-recurring adjustment. Any benefit from the deduction should be reported during the year for which the deduction is claimed on the tax return.

There will be no immediate impact on deferred tax balances for most companies, and deferred taxes will continue to be provided at the statutory tax rate. But accounting for the Act requires judgment. Companies should be prepared to answer these questions:

- Does your company need to provide a larger valuation allowance on its net deferred tax assets due to lower future taxable income?
- Did you consider the impact on the company's effective tax rate when determining the estimated annual rate used for interim financial reporting?
- Did you consider separate disclosure in the effective tax rate reconciliation?
- Did you consider recording an accrual for a potential disallowance of production deductions? This could be necessary due to the need for interpretations on a variety of issues.

Is the company accounting properly for the tax effects of its foreign earnings?

Questions may arise about the tax effects on foreign earnings because the Act provides incentives for companies to return more funds to the United States. These incentives allow a one-time exclusion from taxable income for 85 percent of repatriated foreign earnings.

Guidance on accounting for the repatriation incentives is provided in FSP FAS 109-2, "Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004."

FSP FAS 109-2 gives companies more time to evaluate the impact of the Act on their plans for reinvestment or repatriation of certain foreign earnings for purposes of applying Statement 109. Without this added time, companies would have been required to apply Statement 109 in 2004, even if they had not yet decided whether to keep funds from foreign earnings permanently reinvested outside the United States or to return them to the United States. This decision is critical when applying Statement 109, which provides that:

- A deferred tax liability must be recognized for the excess of the book over the tax basis of investments in foreign subsidiaries or joint ventures.
- An exception is made for the excess attributable to undistributed earnings, if the parent company affirmatively asserts that the earnings are indefinitely reinvested outside its home tax jurisdiction.

These provisions require the recognition of an appropriate deferred tax liability when a company decides to take advantage of the tax incentives and return to the U.S. earnings previously earmarked for reinvestment abroad. The keys to proper accounting:

- Make an accurate determination of the exact time the decision is made so you can record the accrual in the proper accounting period. Don't delay accruing a tax liability until a dividend has been declared or paid.
- Start early to ensure compliance with the disclosure requirements. Some disclosures apply while a company is deciding whether to repatriate earnings under the Act.

Has management put in place proper processes and controls?

The number one question on the minds of many companies is, "Do we have the right processes and controls in place to comply with the new tax law and report its effects accurately?"

Auditors and audit committees may phrase the question differently to drill down to specific areas. For example, an audit committee may question whether controls are in place to ensure that repatriated earnings qualify for beneficial tax treatment.

The repatriations won't qualify unless the dividends are invested in a plan approved by the CEO (or comparable official) or the board of directors. In addition, the repatriated funds must be used for certain qualifying activities. Examples of qualifying activities include funding of worker hiring and training, research and development, and cap-

ital investments that help stabilize the corporation for purposes of job retention and creation.

Importantly, in making and monitoring reinvestment and repatriation decisions, management may rely on cash flow projections and other records that are neither automated nor a routine part of the company's financial reporting system. For example, many companies use spreadsheets to support management decision-making. The awareness of the need for controls over these informal systems was an important breakthrough in 2004.

**The Controls Breakthrough:
How Your Company Can Benefit**

Early efforts by large public companies to comply with the internal control reporting requirements of Section 404 of the Sarbanes-Oxley Act fueled an awareness that controls over spreadsheets may be missing or inadequate. Because this lack of controls increases the potential for errors, (e.g., in input, logic or interfacing with other systems), an understanding of the risks and mitigating controls over spreadsheets can be critical to accurate financial reporting, especially for non-recurring decisions or transactions.

Companies of all sizes can benefit from the knowledge gained by large companies in documenting and evaluating internal controls. In reviewing the accounting changes that apply for the first time to your company's financial statements for 2004 and 2005, be mindful of the need for additional controls and consider discussing the effectiveness of these controls in your ongoing dialogue with auditors and audit committees.

The number one question on the minds of many companies is, "Do we have the right processes and controls in place?"

Accounting for Share-Based Payment

Together, the American Jobs Creation Act and FASB Statement No. 123R introduce important changes that can materially affect executive compensation strategies and plans.

Many companies will find their compensation strategies are no longer aligned with their goals as a result of the American Jobs Creation Act and/or changes in accounting rules. One or both sets of changes is likely to affect your company's senior-level executives and directors, and the effects are likely to be significant since accounting and tax effects are generally prominent considerations when balancing the goals of compensation plans.

Do the company's executive compensation plans still meet its objectives?

Existing compensation plans may no longer meet the company's objectives because the Act imposes numerous requirements on non-qualified deferred compensation plans.

The new tax requirements limit the flexibility of executives and directors by making it more difficult for them to defer compensation through a variety of techniques. For example, several provisions of the Act establish limitations and harsher penalties for withdrawals from deferred compensation plans. The intent was to address concerns that executives, but not rank-and-file employees, were permitted to withdraw funds from deferred compensation plans of failing companies.

Executive stock option plans are generally not affected directly by the changes in the tax law. But they are affected by changes in accounting rules under FASB Statement No. 123, *Share-Based Payment* (revised 2004).

Known as Statement 123R, the revised accounting standard was released in December 2004. It changes the accounting for transactions in which a company receives employee services in exchange for (a) equity instruments of the enterprise or (b) liabilities that are based on the *fair value* of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments.

Importantly, the FASB Statement eliminates the ability to account for equity-based compensation transactions using APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and generally requires instead that such transactions be expensed using a fair-value-based method.

The changes introduced in Statement 123R level the playing field for stock options and alternative forms of compensation. The changes are not required for 2004 financial statements. Based on input from preparers, auditors, valuation firms and the SEC staff, the FASB decided to delay its effective date until 2005. This delay gives companies more time to review and evaluate the alternatives to determine if employee stock

options still are the best way to meet the company's objectives.

Do employee stock options still meet the company's objectives?

Some companies have expressed concern about the long-term impact of the higher costs associated with expensing stock options, for example, the competitiveness of the company and its ability to create and maintain jobs in the years ahead. In an aggregate economic sense, these concerns may be partially offset by the tax relief provided by the Act. But the net effect of the Act and Statement 123R will likely vary by company and industry.

Changes in accounting rules generally require that transactions involving equity-based compensation be expensed using a fair-value-based method.

Under Statement 123R, alternative compensation strategies may better achieve a company's objectives. Here are a few to consider:

- *Restricted stock* is an alternative to stock options, though the tax and incentive effects should be weighed carefully.
- *Performance plans*. Statement 123R removes the detrimental accounting effects of performance conditions in option plans. Including performance conditions can enhance and target the incentive effects of stock options and restricted stock.

- *Cashless exercise features.* Statement 123R removes the detrimental accounting effects of stock options with cashless exercise features or stock appreciation rights settled in shares. These features make exercise more convenient for employees by eliminating their cash outlay.
- *Restructuring noncompensatory plans* is another alternative. Statement 123R narrows the conditions for noncompensatory plans. Employers may want to restructure their existing broad-based employee stock purchase plans to meet the new conditions, so that they continue to be noncompensatory.
- The technique of *accelerated vesting* has been publicized in the media as a way to deal with underwater options prior to the adoption of Statement 123R. If used, accelerated vesting should be accompanied by a heavy dose of disclosures. The SEC staff has said that companies need to adequately disclose their rationale for executing this strategy in anticipation of the adoption of Statement 123R, and the disclosures should be detailed and robust.

Is the company on track to meet both current and future reporting requirements?

For public companies other than small business issuers, Statement 123R is effective for interim or annual periods beginning after June 15, 2005. Small business issuers must adopt in fiscal periods beginning after December 15, 2005, and private companies must adopt in fiscal years beginning after December 15, 2005.

Congress might yet act to delay the effective date of the standard, and the SEC has indicated it may issue additional guidance.

To help companies determine whether they are on track to meet the new requirements, BDO Seidman plans to issue a *Financial Reporting* letter devoted exclusively to Statement 123R in the near future. The letter will be available on our web site at <http://www.bdo.com/services/assurance/index.asp>

The Compensation Breakthrough: How Your Company Can Benefit

The more level playing field provided by Statement 123R provides a better basis for decision-making as well as reporting. Together, the accounting and tax changes give companies and compensation committees an opportunity to rethink their plans and ensure consistency with current compensation and governance objectives.

Companies can use the added time to:

1. Consider changes to their share-based payment plans.
2. Document and test controls related to the Statement prior to its effective date.
3. Assess reporting assumptions and alternatives, such as switching from the Black-Scholes to a lattice model.

Congress might yet act to delay the effective date of the standard, and the SEC has indicated it may issue additional guidance.

Accounting for Discontinued Operations

Recent decisions by the FASB's Emerging Issues Task Force affect income from continuing operations, a key element of financial analysis.

Companies will need to sharpen their pencils soon when calculating income from continuing operations. This line item on the income statement is important to many users of financial statements as a critical element of financial analysis, and it is affected by a consensus reached by the EITF in 2004 on accounting for discontinued operations.

EITF Issue No. 03-13, "Applying the Conditions in Paragraph 42 of FASB Statement No. 144 in Determining Whether to Report Discontinued Operations," takes effect in 2005 and can be adopted early. This Issue can trigger questions from auditors and analysts about how disposals are reported in 2004 financial statements.

Do the financial statements accurately reflect income from continuing operations?

The overall trend in recent years has been to classify more disposals as discontinued operations. This trend began in 2001 when the FASB issued Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Statement 144 expanded the definition of a unit that qualifies as discontinued operations.

Under prior standards, the disposal unit had to be an entire business segment or class of customers. Under Statement 144, it can be a smaller component with distinguishable activities, (e.g., a reportable seg-

ment, operating segment, reporting unit, subsidiary, or asset group).

However, under Statement 144, a disposal is not treated as a discontinued operation if the seller has a continuing business relationship, defined as the existence of either of the following conditions:

- Continuing cash flows related to the disposed component.
- Any significant continuing involvement by the seller in the operations of the disposed component.

Issue 03-13 continues the trend to broader use of the discontinued operation classification by narrowing the conditions for a continuing relationship. It clarifies that:

- Only those continuing cash flows that are *direct cash* flows preclude discontinued operations treatment.
- Direct cash flows can arise when revenues or costs migrate, that is, if the seller continues to sell similar products or services to similar customers of a disposed unit, (e.g., a migration from a disposed bricks-and-mortar store to an e-commerce Internet site.)
- Direct cash flows also can result from a continuation of activities between the seller and the disposed component. Examples include purchase/supply agreements, outsourcing agreements and franchise agreements with a disposed of retail operation.

- The test for a *continuing* involvement is whether the seller retains the ability to influence the operating and/or financial policies of the disposed component.
- A franchise agreement would generally meet the criterion of influence, but neither a financing arrangement nor a cost-method investment would, by itself, provide sufficient evidence of an ability to influence operating or financial policies.

The Analytical Breakthrough: How Your Company Can Benefit

Users of financial statements are playing a greater role in the accounting standard-setting process. The FASB has formed a user advisory committee and appointed security analysts to the EITF. Their input has shown that users are a diverse group. For example, they may differ in whether they view the most important information as pre-tax or after-tax earnings from continuing operations.

The key lessons learned:

1. Make an effort to understand the needs of the key users of your company's financial statements.
2. Consider how they will react to effects of adopting Issue 03-13 on the company's financial statements.
3. Be prepared for questions about how your company's results differ from industry-wide benchmarks for key ratios, such as income from continuing operations (both pre- and post-tax) to revenues.
4. Consider making disclosures that go beyond the minimum requirements.

Accounting for Risks and Contingencies

Criticisms and concerns about insurance practices are causing companies to consider changes that have important accounting implications.

During 2004, a number of criticisms and concerns cast a spotlight on the state-regulated insurance industry and related financial reporting practices. As a result, management may be rethinking the relative merits of the various forms of risk management, such as self-insurance, contracts with insurance companies, and captive insurance subsidiaries.

Do the company's risk management practices still meet its objectives?

Questions about risk management strategies can be triggered by any one of a host of recent developments, including the following:

- Well-publicized investigations by state prosecutors into bid-rigging and contingent commissions.
- Reports and remarks by the Public Company Accounting Oversight Board (PCAOB). The Board has cautioned that it expects (a) companies will have adequate processes and controls for underlying claims data, and (b) auditors will perform sufficient tests of the data, processes, controls, and loss accruals.
- Reports of rating agencies. The reports have criticized the financial reporting practices for finite-risk reinsurance on the grounds that these policies do not transfer or manage risk. Instead, the policies may be used to smooth earn-

ings or they may act as disguised loans when the premium paid for the coverage amounts to a deposit or loan.

Is the company properly reporting its risks and contingencies?

In view of the events described above, BDO Seidman is reminding companies of the accounting guidance for insured and uninsured risks and contingencies:

- A liability should be recorded for any unpaid claims that are probable and reasonably estimable in accordance with FASB Statement No. 5, *Accounting for Contingencies*. The liability should generally be for the gross amount of the loss, even if the entity has purchased insurance to cover the loss.
- When insurance is purchased to cover risks or contingencies, amounts receivable under the insurance contract should not be offset against the liability for unpaid claims. Further, amounts receivable under an insurance contract should be recorded only if realization is probable.
- Companies that purchase insurance must consider whether the contract transfers risk to the insurance company and whether the contract is retroactive or prospective. Guidance on retroactive contracts is provided by EITF Issue

No. 03-8, "Accounting for Claims-Made Insurance and Retroactive Insurance Contracts by the Insured Entity."

- Companies that self-insure must accrue losses for asserted and unasserted claims in accordance with Statement 5. If the liability is significant, the company will likely require the assistance of an actuary to estimate the liability.

Specific guidance applies to companies that buy non-traditional or loss-mitigation insurance policies.

- Statement 5 establishes the accounting for an insurance contract (or reinsurance contract) that does not, despite its form, provide for indemnification of the insured company by the insurer (or reinsurer) against loss or liability. The payment should be accounted for as a deposit.
- FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, provides guidance for insurance companies on the transfer of risk in reinsurance contracts and may provide guidance by analogy for insurance contracts.

The American Institute of CPAs (AICPA) has summarized the guidance on this subject in a technical practice aid (TPA) entitled *Accounting by Noninsurance Enterprises for Property and Casualty Insurance Arrangements That Limit Insurance Risk*. The TPA includes questions and answers about the accounting for and use of finite property and casualty insurance contracts between a policyholder (a noninsurance company) and an insurance enterprise. The TPA can be found on the AICPA's website: http://www.aicpa.org/download/acct-std/Commercial_Insurance_TPA.pdf.

The Insurance Breakthrough: How Your Company Can Benefit

Companies can benefit from the greater awareness of financial reporting practices related to insurance. Some lessons learned:

1. Make sure accounting personnel understand the pertinent terms of the company's insurance policies and the accounting and disclosure requirements.
2. Conduct ongoing evaluations of the company's controls and processes over risks and contingencies.
3. Be sure to assess the accuracy and completeness of liabilities separately from the insurance recoveries related to these liabilities.
4. If the company uses self-insurance, ensure the adequacy of internal controls over the use of actuaries.

Accounting for Inventory Costs and Non-Monetary Exchanges

The FASB issued Statements No. 151 and 153 to help converge U.S. and international accounting standards.

In late 2004, the FASB released the first two statements to result solely from efforts to converge U.S. and international standards. These statements are outcomes of a project undertaken to eliminate differences between the FASB's standards and International Financial Reporting Standards (IFRS) released by the International Accounting Standards Board (IASB).

The FASB selected inventory costs and non-monetary exchanges for the first two convergence standards because any differences eliminated are expected to lead to narrow changes to current U.S. generally accepted accounting principles (GAAP).

The effective dates for both standards were deferred into 2005 because many large U.S. companies were nearing the ends of their long-term projects to ensure compliance with the internal control reporting requirements of Section 404 of the Sarbanes-Oxley Act in late 2004.

A key question for many companies that have inventory costs and/or are considering non-monetary exchanges is whether to early adopt the standards.

Should the company early adopt FASB Statement No. 151?

FASB Statement No. 151, *Inventory Costs – an Amendment of ARB No. 43, Chapter 4*, provides that abnormal

amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current-period charges. It also provides that allocation of fixed production overhead to the costs of conversion should be based on the normal capacity of the production facilities.

Statement 151 applies prospectively to inventory costs incurred during periods beginning after the date of adoption. Application of the Statement is required for fiscal years beginning after June 15, 2005. Earlier adoption is permitted for inventory costs incurred during fiscal years beginning after November 24, 2004.

For many companies, Statement 151 will cause no change in accounting. However, we believe the effects of this statement will vary, and the merits of early adoption should be studied closely.

Should the company early adopt FASB Statement No. 153?

FASB Statement No. 153, *Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29, Accounting for Non-monetary Transactions*, addresses exceptions to the use of fair value for non-monetary exchanges. Currently, Opinion 29 prohibits the use of the fair value for nonmonetary exchanges of *similar productive assets*. Statement 153 removes that exception and replaces it with a general

exception for exchanges of non-monetary assets that do not have *commercial substance*.

The definitions of terms and related accounting requirements follow:

- The term *similar productive assets* used in Opinion 29 means assets that are (a) held for or used in the production of goods or services by an enterprise, and (b) are of the same general type, perform the same function, or are employed in the same line of business. Under Opinion 29, exchanges of these assets are valued at the recorded amount of the nonmonetary assets exchanged (after reduction for an indicated impairment of value, if appropriate).
- An exchange has *commercial substance* as defined in Statement 153 if (a) the configurations of future cash flows (risk, timing, and amount) of the assets differ significantly, or (b) the entity-specific value of the assets received differs significantly from the entity-specific value of the assets exchanged.

Statement 153 is effective prospectively for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. Earlier application is permitted for non-monetary asset exchanges occurring in fiscal periods beginning after December 16, 2004.

We believe considerable judgment may be required to determine whether an exchange has commercial substance and whether the change in cash flows is significant in relation to the fair value of the assets exchanged. Because these areas may raise numerous implementation and interpretation issues, BDO Seidman urges clients affected by Statement 153 to consider its effect and weigh carefully the benefits and risks of early adoption.

Calculating Earnings Per Share

Recent accounting guidance includes EITF consensuses that could significantly reduce reported EPS, both basic and diluted.

The FASB has targeted Statement No. 128, *Earnings per Share*, as one of the next areas of convergence with international accounting standards. The Board expects to issue an amendment early in 2005.

The process of deliberating and redeliberating the EPS standard was something of a balancing act for the FASB in 2004, as the EITF was also discussing emerging developments affecting EPS in the United States. The EITF's consensuses added to the changes being considered as part of the FASB's short-term convergence project.

This standard-setting process left companies sorting through a maze of EPS guidance at year-end 2004. Some chose to rethink their capital structures because the accounting guidance includes EITF consensuses that could significantly reduce reported earnings per share, both basic and diluted.

The key reporting questions relate to participating and contingently convertible securities (co-cos), as well as possible restatements under the planned amendment.

Are participating securities properly reflected in basic EPS?

Basic earnings per share can be significantly reduced by the consensus

reached on EITF Issue No. 03-6, "Participating Securities and the Two-Class Method under FASB Statement No. 128, *Earnings per Share*." The changes introduced by Issue 03-6 have the effect of:

- Expanding the definition of participating securities to include options, warrants, and forward contracts with participating rights, and to include participating rights in forms other than direct sharing in dividends.
- Extending the required use of the two-class method for computing basic EPS to include participating convertible securities. The two-class method reduces basic EPS because it allocates earnings away from common shareholders toward other security holders based on their rights to receive benefits when dividends are declared. The EITF eliminated the alternative of using the if-converted method in basic EPS.

This guidance reflects a change in principle. EPS are lowered when earnings are allocated away from common shareholders and toward other security holders. Previously, the need to do so hinged mainly on the other security holder's right to receive undistributed earnings upon liquidation or redemption. Issue 03-6 changes the basis for the allocation. Now the need to allocate earnings away from common shareholders hinges on the other security

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holder's right to benefit from any dividends that might be declared by the company during the reporting period.

The consensus was effective for periods ended after March 31, 2004, and EPS for prior periods were restated retroactively to apply the consensus.

Are co-cos properly reflected in diluted EPS?

Diluted earnings per share can be significantly reduced by the consensus reached by the EITF in 2004 on Issue No. 04-8, "The Effect of Contingently Convertible Debt on Diluted EPS."

Issue 04-8 indicates that contingently convertible securities should be included in diluted EPS, regardless of whether market price conversion triggers have been met. This guidance represents a change from the treatment prescribed in Statement 128.

Initially, the FASB had planned to amend Statement 128 and make the EITF consensus effective concurrently with the amendment. More recently, due to delays in issuing the amendment, the FASB decided to make the consensus effective for periods ending after December 15, 2004.

Issue 04-8 applies to all securities that have embedded market price conversion features, including contingently convertible preferred stock.

Will the company's reported EPS need to be restated as a result of the coming amendment?

Restatements of EPS are possible as a result of the amendment expected

early in 2005. The amendment is expected to include: (a) changes to the treasury stock method for year-to-date computations, (b) changes to the contingent share guidance for year-to-date computations, (c) the inclusion of mandatorily convertible securities in basic EPS calculations, (d) a requirement to include instruments with possible share settlements in diluted EPS even if the company has the right to settle in cash, and (e) application of the treasury stock method for an instrument that is classified as a liability but could potentially be settled in shares.

Until the amendment is issued and effective, instruments that can be settled either in cash or shares are presumed settled in shares for EPS purposes unless the company can overcome the presumption. The guidelines are as follows:

- The company must be able to provide a reasonable basis for overcoming a presumption that the instrument will be settled in shares.
- The reasonable basis might consist of the company's past practice or a stated policy that the obligation will be settled partially or wholly in cash rather than shares.

The amendment is expected to require companies to assume share settlement in all situations. If so, companies that under existing guidance overcome the presumption of share settlement will need to retroactively restate diluted EPS, unless they amended the terms of such instruments or settled them in cash before December 31, 2004.

The EPS Breakthrough: How Companies Can Benefit

Earnings per share is an important measure of a company's performance. It is a component of the price:earnings ratios used to assess the value of a company, and it plays a pivotal role in determining the value of a company's stock. So consistent and comparable reporting of EPS is key to effective financial reporting. Yet the computations can be complex, and the accounting guidance will continue to change over the coming months in response to both international convergence and U.S. trends.

To avoid risks and benefit from breakthroughs in this area, companies should:

1. Closely monitor the changes and proposed changes.
2. Continually re-evaluate the instruments in their capital structures to ensure the instruments meet the company's myriad objectives, including the tax and accounting implications.
3. Communicate changes to shareholders in a timely manner and in a nontechnical "plain English" style.

The key reporting questions relate to participating and contingently convertible securities (co-cos), as well as possible restatements under the planned amendment.

Financial Reporting by Private, Small and Mid-sized Companies

International convergence adds to the burden on private, small and mid-sized companies of constantly changing, ever more complex accounting standards.

Changes in the accounting standards for inventory costs, nonmonetary exchanges and earnings per share — all reflect the start of a trend. Many more narrowly-scoped changes in accounting standards lie ahead on the road to convergence. The end result is expected to benefit large public companies with cross-border capital-raising transactions and listings on multiple exchanges. But the resulting changes in U.S. accounting standards, added to the normal volume of changes and the increasing complexity of U.S. accounting standards, increase the burden on private, small and mid-sized companies.

Is the company prepared for more accounting changes in 2005?

The international standards known as International Financial Reporting Standards (IFRS) took effect on January 1, 2005 for public companies in Europe. The FASB has expressed its commitment to working with the International Accounting Standards Board (IASB) to eliminate differences between U.S. GAAP and IFRS. The next sets of issues to be addressed are discussed on page 18.

The burden of constantly changing and ever more complex accounting standards on private, small and mid-sized companies prompted

standard-setters and regulators around the world to take action.

Highlights of steps taken in 2004 include the following:

- In June 2004, the IASB issued a discussion paper on “Preliminary Views on Accounting Standards for Small and Medium-Sized Entities.” The purpose was to invite comments on the IASB’s basic approach to developing international accounting standards for them
- In September 2004, the International Federation of Accountants (IFAC) cited challenges for small and medium-sized entities and accounting firms as one of the key obstacles to be overcome in its paper on “Challenges and Successes In Implementing International Standards.” The paper noted that Europe has 7,000 public companies but over one million private entities.
- The challenges cited by the IFAC include: (a) the length and complexity of the international standards, (b) the cost of compliance with IFRS versus the benefits received, (c) the perceived focus on large-entity issues, (d) the lack of sufficient small and medium-sized entity and accounting firm representation on international standard-setting bodies, and (e) the need for a re-education process in connection with statements

used for tax preparation, banking covenants, and other reporting requirements.

- U.S. regulators, standard-setters, and professional associations took steps in 2004 to respond to similar concerns. The FASB formed a small business advisory committee. The AICPA formed a Private Company Financial Reporting Task Force to study the topic of financial reporting for privately held businesses. And the SEC appointed an advisory committee to provide input on accounting standards and financial reporting requirements that apply to smaller public companies.

All these developments reflect a growing awareness of the impact of changing and more complex accounting standards. They also reflect growing concerns about the continuing relevance of U.S. GAAP.

Does existing U.S. GAAP serve the needs of the users of the company’s financial statements?

Due to the combination of the high cost of compliance with the Sarbanes-Oxley Act and recent accounting standards, the focus of the U.S. advisory groups has broadened to include the grass roots question of how effectively existing U.S. GAAP serves the needs of the users of smaller and private companies’ financial statements.

Although there is considerable uncertainty about the outcome of the broader issues, it does seem likely that greater input from the preparers and auditors of private, small and mid-sized companies—groups under-represented in the

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past—will help to shape the future direction of standard-setting projects and regulatory initiatives.

The Convergence Breakthrough: How Your Company Can Benefit

European companies will start using IFRS this year. U.S. companies will be affected more gradually and less directly, but efforts to achieve convergence are likely to result in more changes to U.S. GAAP in 2005. To stay ahead of the trend and help shape future changes:

1. Make an effort to stay informed about the problems and progress of European companies.
2. Stay prepared for changes in U.S. standards by monitoring short-term convergence projects during the year, not just at year-end.
3. Carefully evaluate the effects of early adopting the short-term convergence standards.
4. Communicate your views, either directly to the FASB or through associations and trade groups.

Financial Reporting Using XBRL

Short for eXtensible Business Reporting Language, XBRL “tags” the data in the financial statements to help users extract consistent and comparable information from electronic financial statements.

The needs of investors and other users also sparked a greater awareness in 2004 of the benefits of using XBRL for financial reporting. XBRL, an acronym for eXtensible Business Reporting Language, is an information standard that provides a universal format for a system of tagging data.

Users of financial statements wishing to analyze or compare financial statements typically extract numbers from electronic financial statements and rekey the data into spreadsheets or computer models. Without XBRL, analysis of the electronic financial statements routinely available to investors, creditors, and the general public can be time-consuming and prone to human error.

XBRL “tags” the data in the financial statements and is intended to harness the power of computers to help users extract consistent and comparable information from electronic financial statements. The effects of this tagging have been likened to the effects of barcoding consumer items. The development of the technology was sponsored in part by the AICPA.

Is the company using XBRL? If not, should it adopt XBRL?

In February 2005, the SEC released a rule that allows voluntary financial reporting filings using XBRL. SEC

registrants receive certain legal safe harbors if they voluntarily submit tagged exhibits in XBRL as a way of supplementing their electronic filings on the SEC’s Electronic Data Gathering, Analysis and Retrieval (EDGAR) system. The supplemental data would be submitted as Exhibit 100 to their filings.

The rule indicates that:

- No pre-approval is required to submit the data.
- One submission will not commit a registrant to future XBRL submissions. In other words, the voluntary program will allow companies to stop and resume their XBRL submissions at will.
- The XBRL data on Exhibit 100 will reflect the same information the registrant included in its filing under the Exchange Act of 1934 or the Investment Company Act of 1940. Use of XBRL for the notes to the financial statements is optional.
- The XBRL-Related Documents must be described as “unaudited” or, for quarterly financial statements, “unreviewed.”
- Cautionary language must be provided. The purpose is to advise investors that the program is still in the testing stage and they should not rely on the XBRL data in making investment decisions.

- Submissions designed solely to submit XBRL-Related Documents that present information related to a different filing must reference the official filing form from which the XBRL data was derived.

What are the Costs/Benefits?

The goal of the program is to test and evaluate the XBRL format. The potential costs and benefits include the following:

- The use of XBRL might result in time and cost savings for users of financial statements, who currently rekey and reformat financial information to analyze key ratios, compare companies to peers or indices and perform sophisticated technical analyses.
- The time and cost savings for users may lead to extended analyst coverage for smaller companies, resulting in better information for investors.
- The changes in systems and controls needed to adopt XBRL could affect the level of costs related to Section 404 reporting.
- The use of tagged data might also lead to improvements in controls over financial reporting, (e.g., by automatically checking information in spreadsheets and bridging different internal accounting systems).
- The validation controls and improved consistency in reporting might help the SEC staff review filings and analyze data.

Will XBRL become mandatory? And does it affect non-public companies?

At the conclusion of the test period, the SEC may decide to make XBRL

filing mandatory and it may require auditor attestation of the accuracy and completeness of the tagged data. Alternatively, it might decide to stop the voluntary program, if the costs appear to outweigh the benefits. At the same time, the FASB, lenders, tax authorities and rating agencies are all taking a hard look at the technology. Their reactions will likely help determine the impact on non-public companies.

The FASB appointed an XBRL fellow, and the staff has begun an effort to review and verify the U.S. taxonomy, which is the term used for a dictionary of data definitions needed to support the use of XBRL for a certain discipline – in this case U.S. GAAP.

The initial taxonomy for U.S. GAAP was developed by the U.S. part of an international initiative undertaken by the XBRL Consortium, a group of more than 200 accounting, technology and financial services companies and government and non-government agencies in more than 20 countries.

The taxonomy provides coverage for information in both the financial statements and the notes to the financial statements, and it incorporates references to the authoritative literature applicable to the various elements of financial reporting. These elements include captions on financial statements, such as current assets, and line items, such as cash and cash equivalents. For example, a line item for deferred tax assets would likely be referenced to FASB Statement No. 109, *Accounting for Income Taxes*.

The initial taxonomies under review apply to major industry segments.

There are different taxonomies for commercial and industrial companies, banking and savings institutions and insurance companies. A briefing paper prepared by the FASB's XBRL fellow for the Financial Accounting Standards Advisory Council estimated that, upon initial release, the taxonomies would provide coverage for approximately 90 percent of all publicly listed and private companies.

Potential benefits of XBRL include higher quality and less costly internal controls over financial reporting.

The Technology Breakthrough: How Your Company Can Benefit

Although the use of XBRL holds great potential for the future of financial reporting, there are costs involved in the initial adoption of the tagged data system and there will likely be an experience curve for everyone involved in the financial reporting process. Your company can benefit by getting involved earlier rather than later.

Ways to prepare XBRL statements generally involve:

- Software, either internally-developed or third party.
- Intermediaries, such as financial publishers and filing agents.
- Data aggregators who convert EDGAR filings into a database format, offering services to sort financial data and provide the data in a tagged format.

Other Recent Developments in Accounting and Reporting

Highlights of new reporting requirements for private companies:

- The final part of FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*, dealing with instruments that are mandatorily redeemable on fixed dates for amounts that are fixed or determinable, takes effect for periods beginning after December 15, 2004.
- FASB Interpretation No. 46 (Revised), *Consolidation of Variable Interest Entities*, is effective for fiscal years beginning after December 15, 2004, for variable interest entities created before January 1, 2004.

Additional guidance issued in 2004 is described below.

EITF Consensuses

Consensuses reached by the FASB's Emerging Issues Task Force in 2004 include the following:

Issue No. 02-14, "Whether an investor should apply the equity method of accounting to investments other than common stock if the investor has the ability to exercise significant influence over the operating and financial policies of the investee."

After nearly two years of discussion, the Task Force reached a consensus on Issue 02-14. This consensus indicates that if an investor has the ability to exercise significant influence over an investee, the equity method should be used not only for invest-

ments in common stock, but also for investments in "in substance common stock."

An investment in an entity would be considered in substance common stock if it has risk and reward characteristics that are substantially similar to that entity's common stock. If the results of the risk and reward analysis are not clear, the acid test is whether the changes in the fair value of the investment are expected to be highly correlated with the changes in the fair value of the common stock. If they are, then the investment is in substance common stock and the equity method should be applied if the investor has ability to exercise significant influence over the investee.

Examples of features that create risk and reward characteristics different from common stock include mandatory redemption provisions, dividend or liquidation preferences over common stock, or situations in which the investor does not participate in earnings or capital appreciation in a manner similar to common stock.

Issue No. 03-1, "The meaning of 'other-than-temporary impairment' and its application to certain investments."

The Task Force reached a consensus on the disclosure guidance of Issue 03-1 in 2003 and on the accounting guidance in 2004. The effective date of the accounting guidance of the consensus was subsequently delayed by the FASB in FSP EITF 03-1-1. New

accounting guidance is expected to be issued in 2005.

Until the new guidance is issued, companies should follow the existing literature for determining when a decline in fair value is other-than-temporary. This literature includes SEC SAB Topic 5-M (SAB 59) and the FASB Staff Implementation Guide to FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

Additional guidance for public companies:

- The SEC staff has indicated that SAB 59 requires companies to evaluate whether impairments due to interest rate increases are other-than-temporary.
- If a company sells a security at a loss after previously basing its accounting on the assumption that the security will be held until its value recovers, this can raise concerns about other securities designated as held to recovery. In these cases, the staff has indicated companies should consider the individual facts and circumstances when determining the validity of assertions that other securities will be held to recovery.

Issue No. 03-16, "Accounting for investments in limited liability companies."

Issue 03-16 affects companies that have noncontrolling interests in limited liability companies (LLCs). These companies are business entities with characteristics of both a corporation and a partnership. The issue addresses how to account for an investment in an LLC.

The Task Force reached a consensus that the accounting treatment

should depend on whether the investors have specific ownership accounts:

- If the investors have specific ownership accounts, companies should follow the guidance for partnership investments, that is, a noncontrolling interest should generally be accounted for using the equity method.
- Other investments should follow the guidance for corporate investments. That means a noncontrolling interest should be accounted for using the equity method if the investor has the ability to exercise significant influence over the investee.

Issue No. 04-1, “Accounting for pre-existing contractual relationships between the parties to a purchase business combination.”

Issue 04-1 establishes guidance for recognizing gains or losses for settlement of relationships (e.g., distribution, franchise or supply agreements) that existed between the parties to a business combination prior to the combination.

This consensus requires that settlement of the pre-existing relationship be accounted for as a separate element of the business combination.

The amount of the settlement gain or loss on executory contracts and reacquired rights should be the lesser of: (a) the amount by which the contract or right is favorable or unfavorable to market terms from the perspective of the acquirer, or (b) the amount of any stated settlement provisions of the contract available to the counterparty to which the contract is unfavorable.

Disclosures are required of the nature of the preexisting relationship, the fair value of the assets and liabilities settled and the amount of the settlement gain or loss.

Issue No. 04-2, “Whether mineral rights are tangible or intangible assets.”

Issue 04-2 establishes that mineral rights of mining companies should continue to be accounted for as tangible rather than intangible assets. The FASB staff issued similar guidance establishing that the mineral and drilling rights of oil- and gas-producing entities are tangible assets in FSP FAS 141-1 and 142-1 and FSP FAS 142-2.

Issue No. 04-3, “Mining assets: Impairment and business combinations.”

The Task Force reached a consensus on Issue 04-3 that a measure known as “value beyond proven and probable reserves” should be considered when allocating the purchase price of a business combination to mining assets and when testing for impairment.

Issue No. 04-10, “Applying paragraph 19 of FASB Statement No. 131, Disclosures about Segments of an Enterprise and Related Information, in determining whether to aggregate operating segments that do not meet the quantitative thresholds.”

The Task Force reached a consensus regarding the characteristics necessary for combination of operating information for operating segments that do not individually meet the quantitative thresholds provided in

FASB Statement 131 for reportable segments.

To qualify for combination, the operating segments must have similar economic characteristics *and* they must be similar in a majority of the following five aggregation criteria:

1. The nature of their products and services.
2. The nature of their production processes.
3. The type or class of customer for their products and services.
4. The methods used to distribute their products or provide their services.
5. If applicable, the nature of the regulatory environment, (e.g., banking or insurance).

If the operating segments do not qualify for combination, separate disclosures are required for each segment, regardless of materiality. This consensus will be effective concurrently with an FSP on the meaning of similar economic characteristics. Early application is permitted.

EITF Announcements

The SEC Observer made two announcements in 2004.

Topic No. D-98, “Classification and measurement of redeemable securities.”

The SEC Observer announced the staff’s position regarding the interaction of Topic D-98 and Statement 150 for conditionally redeemable preferred shares:

- If a company issues preferred shares that are conditionally

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redeemable, the shares are outside the scope of Statement 150.

- If the required condition is met, then the shares become mandatorily redeemable under Statement 150 and would require reclassification to a liability.

Topic No. D-108, “Use of the residual method to value acquired assets other than goodwill.”

The SEC Observer announced the SEC staff’s view that the residual method does not meet the requirements of FASB Statement No. 141, *Business Combinations*, for valuing identifiable intangible assets.

Some SEC registrants have used the residual method in the past to value intangibles arising from legal and contractual rights (identifiable intangible assets) on the grounds that these assets could not be directly and separately valued. This method involves assigning a purchase price to other identifiable assets and liabilities, then recognizing the residual amount as an indistinguishable intangible asset.

SEC registrants that have used this method should perform an impairment test on the affected intangible assets using the direct value method no later than the beginning of the first fiscal year after December 15, 2004. Early adoption is encouraged.

FASB Staff Positions

In addition to the FSPs mentioned elsewhere in this letter, the FASB issued the following:

FSP FAS 106-2, Accounting and disclosure requirements related to the Medicare Prescription

Drug, Improvement and Modernization Act of 2003.

This FSP establishes that the subsidy available under the Medicare Act of 2003 is treated as an actuarial gain under FASB Statement No. 106, *Employers’ Accounting for Post-retirement Benefits Other Than Pensions*. This means the effects of the Act on the employer’s accumulated postretirement benefit obligation is combined with all other actuarial gains and losses rather than recorded as a one-time gain.

FSP FAS 129-1, Disclosure requirements under FASB Statement No. 129, Disclosure of Information about Capital Structure, relating to contingently convertible securities.

This FSP establishes disclosure requirements for issuers of contingently convertible securities. The disclosures include the circumstances of the contingency and the potential impact of conversion.

AICPA Statements of Position

The Accounting Standards Executive Committee (AcSEC) of the AICPA released a final SOP in 2004.

SOP No. 04-2, Accounting for Real Estate Time-Sharing Transactions

AcSEC issued SOP 04-2 to address the diversity in practice caused by a lack of guidance specific to real estate time-sharing transactions. Areas of diversity in practice have included accounting for uncollectibles, recovery or repossession of time-sharing intervals, selling and

marketing costs, operations during holding periods, developer subsidies to interval owners associations, and upgrade and reload transactions.

GASB Pronouncements

The Governmental Accounting Standards Board released the following:

Accounting and Reporting for Other Post Employment Benefits (OPEB)

GASB Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, establishes the accounting guidance for OPEB plans that are included as trust funds in the financial reports of plan sponsors or employers, or issued in standalone financial reports.

GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, establishes accounting guidance on how to account for and report the costs and obligations related to postemployment health-care and other forms of OPEB. The accounting requirements are based on actuarial determined amounts similar to requirements for pensions. The OPEB cost is generally the actuarial determined amount that, if paid on an ongoing basis, would provide sufficient resources to pay benefits as they come due.

GASB Technical Bulletin No. 2004-2, “Recognition of Pension and Other Postemployment Benefit [OPEB] Expenditures/Expense and Liabilities by Cost-Sharing Employers,” provides guidance on questions that may arise in applying GASB Statements 27 and 45 to cost-sharing employers. Cost-sharing refers to the

practice of pooling by employers of their benefit obligations and assets under a pension or OPEB plan.

Other GASB Statements

GASB Statement No. 44, *Economic Condition Reporting – The Statistical Section*, enhances and updates the statistical section that accompanies a state or local government's basic financial statements.

GASB Statement No. 46, *Net Assets Restricted by Enabling Legislation*, provides that a government's net assets should be reported as restricted when their use is limited by an external party, constitutional provision, or enabling legislation, (i.e., a law that authorizes new resources but imposes limits on the use of the resources).

Calendar of Key Accounting and Reporting Dates

2004

June 15, 2004

Certain provisions of FASB Statement No. 132(R), *Employers' Disclosures about Pensions and Other Postretirement Benefit*, took effect for fiscal years ending after this date. These provisions include:

- Disclosure of certain information about foreign plans.
- Disclosure of future benefit payments.
- Disclosure of information for nonpublic entities.

December 15, 2004

Several major accounting standards took effect for private companies as of this date:

- Private companies must apply certain provisions of FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*, for fiscal periods beginning after this date. These provisions address instruments that are mandatorily redeemable on fixed dates for amounts that are fixed or determinable.
- Private companies must apply FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities*, to variable interest entities created before January 1, 2004 during the first annual period beginning after December 15, 2004.

2005

June 15, 2005

Several accounting standards take effect as of this date:

- Public entities that do not file as small business issuers must adopt FASB Statement No. 123(R), *Share-Based Payment*, as of the beginning of the first interim or annual reporting period that begins after June 15, 2005.
- FASB Statement No. 151, *Inventory Costs – An Amendment of ARB No. 43, Chapter 4*, takes effect for inventory costs incurred during fiscal years beginning after June 15, 2005.
- FASB Statement No. 152, *Accounting for Real Estate Time-Sharing Transactions*, and AICPA Statement of Position No. 04-2, *Accounting for Real Estate Time-Sharing Transactions*, are effective for fiscal years beginning after June 15, 2005.
- FASB Statement No. 153, *Exchanges of Nonmonetary Assets*, is effective for non-monetary asset exchanges occurring in fiscal periods beginning after June 15, 2005.

December 15, 2005

FASB Statement No. 123(R), *Share-Based Payment*, takes effect for small business issuers and nonpublic entities.

- Public entities that file as small business issuers must adopt Statement 123(R) as of the beginning of the first interim or annual reporting period that begins after December 15, 2005.
- Nonpublic entities must adopt Statement 123(R) as of the beginning of the first annual reporting period that begins after December 15, 2005.

The Outlook for More Breakthroughs in 2005

Additional breakthroughs may unfold in the year ahead. But there are pitfalls to avoid.

The mini-breakthroughs of 2004 were real, and they gave us reason for optimism. 2005 brings the potential for even bigger breakthroughs, but there are also pitfalls to avoid. Below are a few key areas to watch, along with our views and predictions.

1 The Promise of Principles-Based Standards

The elusive goal of principles-based standards will help shape standards issued in 2005 and beyond. We expect the FASB will continue to seek out ways to make its standards less “rules-based” and more “principles-based” or “objectives-oriented.”

But real progress will demand more innovative thinking to define the goals and measure the risks and rewards in a more precise manner.

Today's renewed emphasis on internal controls may pay unexpected dividends in this regard. In the past, some standards may have been rushed into effect, resulting in transition times too short to put the needed controls in place. Others may have required processes or systems that were costly to control and audit.

To learn from past mistakes, standard-setters and regulators need to build on these findings and factor into the goals of principles-based

standards a more rigorous cost/benefit analysis. Ideally, the benefits analysis should focus on the needs of the various users of financial statements and consider the values of different types of information to different classes of users. Just as important, the costs should include the risks and consequences of making the wrong judgment or arriving at the wrong interpretation, despite a good-faith attempt to comply with principles-based standards.

If I have seen further than others, it is by standing upon the shoulders of giants.

Sir Isaac Newton
1676

2 More Changes from International Convergence

The application of a more rigorous cost/benefit analysis will be especially important when weighing the need for additional convergence standards. Several short-term convergence projects are scheduled for completion in 2005. These projects could result in revisions to the standards for accounting changes and error corrections, income taxes, and research and development costs.

Accounting Changes

An exposure draft on accounting changes and error corrections was released in late 2003. If adopted as a final standard, this proposed standard would:

- Require that voluntary changes in accounting policies be applied by retroactive restatement.
- Require the use of retroactive restatement as the standard transition method for new accounting standards, unless a new pronouncement contains other specific transition guidance.

This proposal has met with resistance from those who fear restatement has taken on unfavorable connotations among users of financial statements. The concern is that these perceptions can be strong enough to outweigh any benefits of convergence.

Income Taxes

An exposure draft on accounting for income taxes is expected in 2005. The purposes of this ED are to:

- Eliminate some of the exceptions to the comprehensive deferred tax asset and liability principles of Statement 109. For example, the FASB has tentatively decided to eliminate the exceptions for intercompany transfers and foreign currency translation.
- Address certain “structural” differences with the international standard. These differences involve the use of backward tracing for interperiod tax allocation and the deferred tax assets arising in asset acquisitions other than a business combination.

Convergence on income taxes may prove difficult as the standards continue to respond to other events and trends. The FASB also plans to issue interpretations to address uncertain tax positions and the effects of income tax changes on the accounting for leveraged leases.

Research and Development

Although no specific timetable has been set, the FASB agreed in 2004 to try to eliminate differences with the international accounting standard for research and development. The primary focus is on the requirements related to initial recognition of intangible assets acquired in transactions other than a business combination.

A basic difference between U.S. GAAP and IFRS is that:

- The international standard makes a distinction between research and development and requires capitalization of development costs in certain circumstances.
- U.S. GAAP makes no distinction between research and development and generally requires both types of costs to be expensed when incurred.

The two Boards may try to build on the thinking in FASB Statement No. 86, *Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed*, as a framework for capitalizing internally-generated intangible assets.

3 A Bridge for the Gaps in Fair Value Measurement

The use of fair value measurement is a key area in which the costs and benefits have been especially diffi-

cult to measure. In what some have likened to the calm before the storm, the FASB released an exposure draft of a proposed statement on *Fair Value Measurement* in 2004. The intent of the proposed statement is not to introduce any new requirements for the use of fair value, but rather to provide uniform guidance on the definition and measurement of fair value.

The number of statements that require the use of fair value continues to grow, and the concept of fair value continues to evolve. As a result, the FASB felt it was time to bridge the gaps in the literature and reconcile the inconsistencies that have developed over time.

We build too many walls and not enough bridges.

Sir Isaac Newton

Critics of fair value measurement fear that, if and when a final statement is issued, it may serve as a signal to expand the use of this principle and move more elements of financial reporting across the bridge into the world of fair value measurement.

We are encouraged by the body of literature that is developing around the auditing of fair values. We hope the use of fair values won't be expanded without carefully weighing all the relevant risks and rewards in a rigorous cost/benefit analysis.

4 New Rules for Contingent Asset Retirement Obligations

In 2004, the FASB issued an exposure draft of a proposed Interpretation on *Accounting for Conditional Asset Retirement Obligations*. The biggest change in practice that would result from the ED is that the fair value of a conditional asset retirement obligation would be recognized when the obligation is incurred or as soon as the liability's fair value can be reasonably estimated.

A conditional asset retirement obligation is a legal obligation to take certain actions if and when a tangible long-lived asset is retired. An example would be the legal obligation to remove and dispose of asbestos, when a building is renovated or demolished. In this example, the asset retirement activity is viewed as "conditional" because it depends on a future event—renovation or demolition.

Current practice with respect to such obligations is mixed:

- Some companies interpret Statement 143 and Concepts Statement 6 to say that no liability exists until the triggering event becomes probable.
- Others have interpreted the literature to say that a liability exists and the probability of the triggering event affects the amount of the liability.

The ED embraces the second interpretation, (i.e., that a liability exists because of the legal obligation and that probability affects the measurement of the liability at fair value). In effect, this is a purer fair value model.

Financial Reporting

Despite its seemingly purer conceptual basis, the use of fair values for conditional future events is not without hazards, mostly because it introduces more risks and uncertainties associated with future events into the financial statements.

Companies are protected from liability by the safe harbor for forward-looking information provided in the Private Securities Litigation Act of 1995, provided they use appropriate cautionary language to identify the risks and uncertainties. But this safe harbor does not extend to financial statements. Because the cost of making a good-faith mistake could be substantial, we believe this risk should be weighed against the benefits.

5 Changing the Model for Business Combinations

Similar to the position taken by the FASB on contingent asset retirement obligations, the tentative conclusions of phase II of the FASB business combinations project reflect a more purist fair value approach to business combinations.

Below is an overview of the FASB's current thinking as to areas in which future accounting for business combinations would differ from today's accounting.

Potential Changes in Applying the Purchase Method of Accounting for Business Combinations

- Today's purchase accounting starts with purchase cost, including direct transaction costs, and allocates it to the acquired assets and liabilities based on relative fair values. There are exceptions, such as contingent consideration,

which generally isn't recorded until the contingency is resolved.

- The proposed approach excludes transaction costs from purchase cost (because the FASB reasons that transactions costs don't represent part of the fair value of the acquired business). It also requires the buyer to estimate the fair value of contingent consideration and record it as a liability as part of purchase accounting. Any difference between fair value estimated at closing and actual payments would be an adjustment to the income statement because it would represent subsequent changes rather than fair value at the purchase date.
- The guidance on individual acquired assets and liabilities is also more detailed and intended to be closer to true fair value rather than an allocated amount.

Potential Changes in Accounting for Minority Interests

In addition, minority (noncontrolling) interests in consolidated subsidiaries would be classified as a component of equity rather than as a liability. As currently proposed by the FASB, this approach would substantially change the accounting for step acquisitions and dispositions. For example:

- A company that previously owned a noncontrolling interest in an entity would adjust that investment to fair value and recognize a gain or loss upon achieving control.
- Upon achieving control, the noncontrolling interest would be recorded at fair value, not at carryover basis.

- Further purchases after gaining control would be treasury stock transactions.
- No gain or loss would be recorded on partial dispositions unless they resulted in losing control.

Next Steps

The FASB has posted its tentative conclusions on this project to its website. If your company is an active acquirer, we recommend getting familiar with the proposed changes.

Our initial reaction is that on the whole the proposed changes are a step backwards, imposing heavy costs on both preparers and users of financial statements with little benefit.

We cannot solve our problems with the same thinking we used when we created them.

Albert Einstein

6 Changing Roles for Auditors and Chief Financial Officers

As changes in accounting standards continue to evolve, future CFOs and auditors will face a tough new set of challenges. The driving forces:

- The trends toward convergence, principles-based standards and greater use of fair values all complicate the movement toward a tougher regulatory and enforcement environment. These trends result in accounting rules that are complex, constantly changing, and difficult to apply without consul-

tations with auditors and outside experts.

- So pronounced are the trends in accounting standards that critics predict the world may soon see the day when it is no longer possible for an accountant to master all the authoritative literature and apply it without the aid of an army of specialists. Indeed, some say that day has already dawned.
- Yet rigorous ethical standards increasingly call for greater separation of audits and non-audit services, causing companies to deal with an increasing number of accounting and consulting firms to find the necessary specialists.
- At the same time, internal control requirements for public companies encourage preparers of financial statements to make their own interpretations of complex standards rather than relying on their auditors' interpretation.

These challenges demand innovative thinking. By rising to the challenge, academics, preparers, audi-

tors, regulators and standard-setters all can help ensure that financial reporting will continue to evolve and improve. The keys to success will include a rigorous cost-benefit analysis, a concerted effort to avoid overloading the system, and a conscious effort to weigh the impact on private, small and mid-sized companies.

Both auditors and CFOs will need to be prepared for change. But the breakthroughs of 2004 give us reason for optimism. Changing roles can succeed, if we continue to build on knowledge, one step at a time, step by step, breakthrough by breakthrough.

For more updates

The following publications provide more details about the accounting matters mentioned in this letter. They are available on BDO's web site at <http://www.bdo.com/services/assurance/>.

- Employers Brace for Expected Changes in Accounting for Stock Options
- FASB Statement No. 150 Brings Big Changes
- New Accounting Rules for VIEs – aka SPEs
- SEC Year in Review – Significant 2004 Developments
- SEC Insights – 2004

The following publications provide more details about the tax matters mentioned in this letter. They are available on BDO's web site at <http://www.bdo.com/about/publications/tax/index.asp>

- *Washington Tax Report* – Deduction for Domestic Production Activities Income
- *Washington Tax Report* - American Jobs Creation Act of 2004

You may also wish to join us for our quarterly conference calls on new accounting development. For more information, see <http://www.bdo.com/about/publications/assurance/index.asp>.

Listing of Recent Pronouncements

Type of Pronouncement	Title and Date of Issuance
FASB Statements	<p>Statement 123(R). <i>Share-Based Payment (Revised 2004)</i>. (Issued: December 2004.)</p> <p>Statement 132(R). <i>Employers' Disclosures about Pensions and Other Postretirement Benefits (Revised 2003)</i>. (Issued: December 2003.)</p> <p>Statement 150. <i>Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity</i>. (Issued: May 2003.)</p> <p>Statement 151. <i>Inventory Costs</i>. (Issued: November 2004.)</p> <p>Statement 152. <i>Accounting for Real Estate Time-Sharing Transactions</i>. (Issued: December 2004.)</p> <p>Statement 153. <i>Exchanges of Nonmonetary Assets</i>. (Issued: December 2004.)</p>
FASB Interpretations	<p>Interpretation 46(R). <i>Consolidation of Variable Interest Entities (Revised 2003)</i>. (Issued: December 2003.)</p>
FASB Staff Positions (FSPs)	<p>FSPs Related to EITF Issues</p> <p>FSP EITF 03-1-1. Effective Date of Paragraphs 10-20 of EITF Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments." (Released September 30, 2004.)</p> <p>FSPs Related to Interpretation 46(R)</p> <p>FSP FIN 46(R)-1. Reporting Variable Interests in Specified Assets of Variable Interest Entities as Separate Variable Interest Entities under Paragraph 13 of FASB Interpretation No. 46 (Revised December 2003), <i>Consolidation of Variable Interest Entities</i>. (Released: February 12, 2004.)</p> <p>FSP FIN 46(R)-2. Calculation of Expected Losses under FASB Interpretation No. 46 (Revised December 2003), <i>Consolidation of Variable Interest Entities</i>. (Released: February 12, 2004.)</p> <p>FSP FIN 46(R)-3. Evaluating Whether as a Group the Holders of the Equity Investment at Risk Lack the Direct or Indirect Ability to Make Decisions about an Entity's Activities through Voting Rights or Similar Rights under FASB Interpretation No. 46 (Revised December 2003), <i>Consolidation of Variable Interest Entities</i>. (Released: February 12, 2004.)</p> <p>FSP FIN 46(R)-4. Technical Correction of FASB Interpretation No. 46 (Revised December 2003), <i>Consolidation of Variable Interest Entities</i>, Relating to Its Effects on Question No. 12 of EITF Issue No. 96-21, "Implementation Issues in Accounting for Leasing Transactions Involving Special-Purpose Entities." (Released: April 30, 2004.)</p>

Table I

Listing of Recent Pronouncements (cont'd)

Type of Pronouncement	Title and Date of Issuance
FASB Staff Positions (FSPs)	<p data-bbox="602 457 976 485">FSPs Related to FASB Statements</p> <p data-bbox="602 506 1471 625">FSP FAS 97-1. Situations in Which Paragraphs 17(b) and 20 of FASB Statement No. 97, <i>Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments</i>, Permit or Require Accrual of an Unearned Revenue Liability. (Released: June 18, 2004.)</p> <p data-bbox="602 646 1471 737">FSP FAS 106-1. Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003. (Released: January 12, 2004.)</p> <p data-bbox="602 758 1471 848">FSP FAS 106-2. Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003. (Released: May 19, 2004.)</p> <p data-bbox="602 869 1471 959">FSP FAS 109-1. Application of FASB Statement No. 109, <i>Accounting for Income Taxes</i>, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004. (Released: December 21, 2004.)</p> <p data-bbox="602 980 1471 1071">FSP FAS 109-2. Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004. (Released: December 21, 2004.)</p> <p data-bbox="602 1092 1471 1182">FSP FAS 129-1. Disclosure Requirements under FASB Statement No. 129, <i>Disclosure of Information about Capital Structure</i>, Relating to Contingently Convertible Securities. (Released: April 9, 2004.)</p> <p data-bbox="602 1203 1471 1320">FSP FAS 141-1 and FSP FAS 142-1. Interaction of FASB Statements No. 141, <i>Business Combinations</i>, and No. 142, <i>Goodwill and Other Intangible Assets</i>, and EITF Issue No. 04-2, "Whether Mineral Rights Are Tangible or Intangible Assets." (Released: April 30, 2004.)</p> <p data-bbox="602 1341 1471 1398">FSP FAS 142-2. Application of FASB Statement No. 142, <i>Goodwill and Other Intangible Assets</i>, to Oil- and Gas-Producing Entities. (Released: September 2, 2004.)</p> <p data-bbox="602 1419 1471 1537">FSP FAS 150-1. Issuer's Accounting for Freestanding Financial Instruments Composed of More Than One Option or Forward Contract Embodying Obligations under FASB Statement No. 150, <i>Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity</i>. (Released: October 16, 2003.)</p> <p data-bbox="602 1558 1471 1675">FSP FAS 150-2. Accounting for Mandatorily Redeemable Shares Requiring Redemption by Payment of an Amount That Differs from the Book Value of Those Shares under FASB Statement No. 150, <i>Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity</i>. (Released: October 16, 2003.)</p> <p data-bbox="602 1696 1471 1850">FSP FAS 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, <i>Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity</i>. (Released: November 7, 2003.)</p> <p data-bbox="602 1871 1471 1961">FSP FAS 150-4. Issuers' Accounting for Employee Stock Ownership Plans under FASB Statement No. 150, <i>Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity</i>. (Released: November 7, 2003.)</p>

Listing of Recent Pronouncements (cont'd)

Type of Pronouncement	Title and Date of Issuance
EITF Issues	<p>EITF Issue No. 02-14. "Whether an Investor Should Apply the Equity Method of Accounting to Investments other than Common Stock."</p> <p>EITF Issue No. 03-1. "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments."</p> <p>EITF Issue No. 03-6. "Participating Securities and the Two-Class Method under FASB Statement No. 128, Earnings per Share."</p> <p>EITF Issue No. 03-13. "Applying the Conditions in Paragraph 42 of FASB Statement No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," in Determining Whether to Report Discontinued Operations."</p> <p>EITF Issue No. 03-16. "Accounting for Investments in Limited Liability Companies."</p> <p>EITF Issue No. 04-1. "Accounting for Pre-Existing Contractual Relationships between the Parties to a Purchase Business Combination."</p> <p>EITF Issue No. 04-2. "Whether Mineral Rights are Tangible or Intangible Assets."</p> <p>EITF Issue No. 04-3. "Mining assets: Impairment and Business Combinations."</p> <p>EITF Issue No. 04-8. "The Effect of Contingently Convertible Debt on Diluted Earnings per Share."</p> <p>EITF Issue 04-10. "Determining Whether to Aggregate Operating Segments That Do Not Meet the Quantitative Thresholds."</p>
Announcements made at EITF Meetings	<p>EITF Topic No. D-98. SEC Staff Announcement. "Classification and Measurement of Redeemable Securities."</p> <p>Topic No. D-108. SEC Staff Announcement. "Use of the Residual Method to Value Acquired Assets Other Than Goodwill."</p>
AICPA Statements of Position	<p>SOP 03-3. <i>Accounting for Loans or Certain Debt Securities Acquired in a Transfer</i>. (Issued: December 12, 2003.)</p> <p>SOP 04-2. <i>Accounting for Real Estate Time-Sharing Transactions</i>. (Issued: December 2004.)</p>
AICPA Practice Aids	<p>Practice Aid. <i>Valuation of Privately-Held-Company Equity Securities Issued as Compensation</i>. (Issued: April 2004.)</p>
GASB Statements and Technical Bulletins	<p>GASB Statement No. 40. <i>Deposit and Investment Risk Disclosures, an amendment of GASB Statement No. 3</i>. (Issued: March 2003.)</p> <p>GASB Statement No. 42. <i>Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries</i>. (Issued: November 2003.)</p> <p>GASB Statement No. 43. <i>Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans</i>. (Issued: May 2004.)</p>

Table I

Listing of Recent Pronouncements (cont'd)

Type of Pronouncement	Title and Date of Issuance
GASB Statements and Technical Bulletins (continued)	<p>GASB Statement No. 44. <i>Economic Condition Reporting - The Statistical Section – An Amendment of NCGA Statement 1.</i> (Issued: June 2004.)</p> <p>GASB Statement No. 45. <i>Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions.</i> (Issued: August 2004.)</p> <p>GASB Statement No. 46. <i>Net Assets Restricted by Enabling Legislation – An Amendment of GASB Statement No. 34.</i> (Issued: December 2004.)</p> <p>GASB Technical Bulletin No. 2004-1. <i>Tobacco Settlement Recognition and Financial Reporting Entity Issues.</i> (Issued: May 2004.)</p> <p>GASB Technical Bulletin No. 2004-2. <i>Recognition of Pension and Other Postemployment Benefit [OPEB] Expenditures/Expense and Liabilities by Cost-Sharing Employers.</i> (Issued: December 2004.)</p>
FASB Exposure Drafts	<p>Proposed Statement of Financial Accounting Standards. <i>Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3.</i> (Issued: December 15, 2003. Comment period ended April 13, 2004.)</p> <p>Proposed Statement of Financial Accounting Standards. <i>Earnings per Share—an amendment of FASB Statement No. 128.</i> (Issued: December 15, 2003. Comment period ended April 13, 2004.)</p> <p>Proposed Statement of Financial Accounting Standards. <i>Qualifying Special-Purpose Entities and Isolation of Transferred Assets—an amendment of FASB Statement No. 140.</i> (Issued: June 10, 2003. Comment period ended July 31, 2003.)</p> <p>Proposed Interpretation. <i>Accounting for Conditional Asset Retirement Obligations—an interpretation of FASB Statement No. 143.</i> (Issued: June 17, 2004. Comment period ended August 1, 2004.)</p> <p>Proposed Statement of Financial Accounting Standards. <i>Fair Value Measurements.</i> (Issued: June 23, 2004. Comment period ended September 7, 2004.)</p>
AICPA Exposure Drafts	<p>Proposed SOP. <i>Accounting by Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements.</i> (Revised ED issued: November 2004. Comment period ended: January 7, 2005.)</p> <p>Proposed SOP. <i>Allowance for Credit Losses.</i> (Issued: June 2003. Comment period ended September 19, 2003.)</p>
GASB Exposure Drafts	<p>GASB Exposure Draft No. E-58. Proposed Statement, <i>Communication Methods.</i> (Issued: June 2004.)</p> <p>GASB Exposure Draft No. E-60. Proposed Statement, <i>Accounting for Termination Benefits.</i> (Issued: December 2004.)</p>

Summary of Effective Dates

Pronouncements	Effective Dates
<p>FASB Statement No. 123(R), <i>Share-Based Payment</i></p>	<p>Statement 123(R) is effective in stages:</p> <ul style="list-style-type: none"> Public entities that do not file as small business issuers must adopt the standard as of the beginning of the first interim or annual reporting period that begins after June 15, 2005 Public entities that file as small business issuers must adopt as of the beginning of the first interim or annual reporting period that begins after December 15, 2005 Nonpublic entities must adopt as of the beginning of the first annual reporting period that begins after December 15, 2005. <p>Statement 123, as originally issued, is effective until the provisions of Statement 123(R) are adopted.</p>
<p>FASB Statement No. 132(R), <i>Employers' Disclosures about Pensions and Other Postretirement Benefit</i></p>	<p>Statement 132(R)'s new or revised disclosure requirements are effective according to the following schedule:</p> <ul style="list-style-type: none"> Annual disclosures: fiscal years ending after December 15, 2003. Interim period disclosures: interim periods beginning after December 15, 2003. <p><i>Exceptions:</i> (a) Disclosure of certain information about foreign plans is effective for fiscal years ending after June 15, 2004. (b) Disclosure of future benefit payments is effective for fiscal years ending after June 15, 2004. (c) Disclosure of information for nonpublic entities is effective for fiscal years ending after June 15, 2004. Special disclosure requirements apply when the financial statements exclude information about foreign plans during the transition period.</p> <p><u>Rules for restatements:</u> Disclosures for earlier annual periods presented for comparative purposes must be restated for (a) the percentages of each major category of plan assets held, (b) the accumulated benefit obligation, and (c) the assumptions used in the accounting for the plans. The disclosures for earlier interim periods presented for comparative purposes must be restated for the components of net benefit cost.</p> <p><i>Exceptions:</i> If obtaining the information relating to earlier periods is not practicable, the notes to the financial statements must include all available information and identify the information not available.</p>
<p>FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity</p>	<p><u>Original effective date:</u> For mandatorily redeemable shares of private companies, Statement 150 originally was effective for fiscal periods beginning after December 15, 2003. For all other instruments in the scope of Statement 150, the effective dates were as follows:</p> <ul style="list-style-type: none"> Immediately, for instruments entered into or modified after May 31, 2003. The first interim period beginning after June 15, 2003 for preexisting instruments. <p><u>Revised effective dates:</u> As a result of the partial deferrals made by FSPs, the effective dates for the standard are now as follows:</p> <ul style="list-style-type: none"> <i>Private companies.</i> For instruments that are mandatorily redeemable on fixed dates for amounts that are fixed or determinable Statement 150 is effective for fiscal

(continued on next page)

Table 2

Summary of Effective Dates (cont'd)

Pronouncements	Effective Dates
<p>FASB Statement No. 150, <i>Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity</i> (continued)</p>	<p>periods beginning after December 15, 2004. For other mandatorily redeemable shares issued by private companies, the requirements were deferred indefinitely.</p> <ul style="list-style-type: none"> • <i>All companies</i>. For noncontrolling interests in consolidated subsidiaries that are deemed mandatorily redeemable only because the issuing entity has a limited life, the classification and measurement provisions are deferred indefinitely (and early adoption is precluded). For other types of mandatorily redeemable noncontrolling interests in consolidated subsidiaries created before November 5, 2003, the measurement provisions of Statement 150 are deferred indefinitely. <p>There was no change in the effective dates for other types of instruments.</p>
<p>FASB Statement No. 151, <i>Inventory Costs – An Amendment of ARB No. 43, Chapter 4</i></p>	<p>Statement 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. Earlier application is permitted for inventory costs incurred during fiscal years beginning after November 24, 2004. The provisions of this Statement should be applied prospectively.</p>
<p>FASB Statement No. 152, <i>Accounting for Real Estate Time-Sharing Transactions</i></p>	<p>Statement 152 is effective for fiscal years beginning after June 15, 2005. Restatement of previously issued financial statements is not permitted.</p>
<p>FASB Statement No. 153, <i>Exchanges of Nonmonetary Assets</i></p>	<p>Statement 153 is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. Earlier application is permitted for nonmonetary asset exchanges occurring in fiscal periods beginning after December 16, 2004. The provisions of this Statement should be applied prospectively.</p>
<p>AICPA SOP No. 03-3, <i>Accounting for Loans or Certain Debt Securities Acquired in a Transfer</i></p>	<p>SOP 03-3 is effective for loans acquired in fiscal years beginning after December 15, 2004. Previously issued annual financial statements should not be restated. Early application of this SOP is encouraged, but not required, for transfers of loans subsequent to the issuance of this SOP but prior to the effective date.</p>
<p>AICPA SOP No. 04-2, <i>Accounting for Real Estate Time-Sharing Transactions</i></p>	<p>SOP 04-2 is effective for fiscal years beginning after June 15, 2005. Earlier application is encouraged as of the beginning of fiscal years for which financial statements or information have not been issued. Previously issued financial statements should not be restated.</p>
<p>GASB Statement No. 40, <i>Deposit and Investment Risk Disclosures, an amendment of GASB Statement No. 3</i></p>	<p>Statement 40 is effective for financial statements for periods beginning after June 15, 2004. Earlier application is encouraged.</p>

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Summary of Effective Dates (cont'd)

Pronouncements	Effective Dates
<p>GASB Statement No. 42, <i>Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries</i></p>	<p>Statement 42 is effective for financial statements for periods beginning after December 15, 2004. Earlier adoption is encouraged. Accounting changes adopted to conform to the provisions of this Statement should be applied retroactively by restating financial statements, if practical, for all prior periods presented. If restatement is not practical, the cumulative effect of applying this Statement, if any, should be reported as a restatement of beginning net assets, fund balances, or fund equity, as appropriate, for the earliest period restated. In the period this Statement is first applied, the financial statements should disclose the nature of any restatement and its effect. Also the reason for not restating prior periods presented should be explained. Previously reported impairments, if any, resulted in a new cost basis for the impaired capital asset and should not be restated.</p>
<p>GASB Statement No. 43, <i>Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans</i></p>	<p>The requirements of Statement 43 for OPEB plan reporting are effective <i>one year prior</i> to the effective date of the related Statement for the employer (single-employer plan) or for the largest participating employer in the plan (multiple-employer plan). The requirements of the related Statement are effective in three phases based on a government's total annual revenues, as defined in that Statement, in the first fiscal year ending after June 15, 1999—the same criterion used to determine a government's phase for implementation of GASB Statement No. 34, <i>Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments</i>.</p> <ul style="list-style-type: none"> • Plans in which the sole or largest participating employer is a <i>phase 1 government</i> (those with total annual revenues of \$100 million or more) are required to implement this Statement in financial statements for periods beginning after December 15, 2005. • Plans in which the sole or largest participating employer is a <i>phase 2 government</i> (total annual revenues of \$10 million or more but less than \$100 million) are required to implement this Statement in financial statements for periods beginning after December 15, 2006. • Plans in which the sole or largest participating employer is a <i>phase 3 government</i> (total annual revenues of less than \$10 million) are required to implement this Statement in financial statements for periods beginning after December 15, 2007. <p>If comparative financial statements are presented, restatement of the prior-year financial statements is required. Early implementation of this Statement is encouraged.</p>
<p>GASB Statement No. 44, <i>Economic Condition Reporting - The Statistical Section - An Amendment of NCGA Statement 1</i></p>	<p>The provisions of Statement 44 are effective for statistical sections prepared for periods beginning after June 15, 2005. Governments that prepare a statistical section for the first time in response to this Statement (or that previously prepared a statistical section but did not present certain information) are encouraged, but not required, to report all required years of information retroactively. Governments are encouraged, but not required, to implement the government-wide information</p>

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Table 2

Summary of Effective Dates (cont'd)

Pronouncements	Effective Dates
<p>GASB Statement No. 44, <i>Economic Condition Reporting - The Statistical Section - An Amendment of NCGA Statement 1</i> continued</p>	<p>required by this Statement retroactively to the year they implemented Statement 34. If information required by this Statement differs from information previously reported by governments, governments are encouraged, but not required, to restate or revise the information for previous years. If the information for previous years is not restated or revised, governments should clearly indicate the year of implementation of the information required by this Statement and explain the nature of the differences from prior information.</p>
<p>GASB Statement No. 45, <i>Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions</i></p>	<p>Statement 45 generally provides for prospective implementation—that is, that employers set the beginning net OPEB obligation at zero as of the beginning of the initial year. Implementation is required in three phases based on a government's total annual revenues in the first fiscal year ending after June 15, 1999. The definitions and cutoff points for that purpose are the same as those in Statement 34. This Statement is effective for periods beginning after December 15, 2006, for <i>phase 1 governments</i> (those with total annual revenues of \$100 million or more); after December 15, 2007, for <i>phase 2 governments</i> (those with total annual revenues of \$10 million or more but less than \$100 million); and after December 15, 2008, for <i>phase 3 governments</i> (those with total annual revenues of less than \$10 million). Earlier implementation is encouraged.</p>
<p>GASB Statement No. 46, <i>Net Assets Restricted by Enabling Legislation - An Amendment of GASB Statement No. 34</i></p>	<p>The requirements of GASB Statement 46 are effective for financial statements for periods beginning after June 15, 2005. Earlier application is encouraged. Accounting changes adopted to conform to the provisions of this Statement should be applied retroactively by reclassifying net asset information, if practical, in financial statements for all prior periods presented. In the period this Statement is first applied, the financial statements should disclose the nature of any reclassification and its effect. Also, the reason for not reclassifying net asset information for prior periods presented should be explained.</p>
<p>GASB Technical Bulletin No. 2004-1, <i>Tobacco Settlement Recognition and Financial Reporting Entity Issues</i></p>	<p>Technical Bulletin 2004-1 is effective for financial statements for periods ending after June 15, 2004. Earlier application is encouraged. Adjustments resulting from a change to comply with this Technical Bulletin should be treated as adjustments of prior periods. The financial statements of all prior periods presented should be restated, if practical, to show the financial information of the new reporting entity for all periods. If restatement of the financial statements for prior periods is not practical, the cumulative effect of applying this Technical Bulletin should be reported as a restatement of beginning net assets/fund balance for the earliest period restated. In the period this Technical Bulletin is first applied, the financial statements should disclose the nature of the restatement and its effect.</p>
<p>GASB Technical Bulletin No. 2004-2, <i>Recognition of Pension and Other Postemployment Benefit [OPEB] Expenditures/Expense and Liabilities by Cost-Sharing Employers</i></p>	<p>For pension transactions, Technical Bulletin 2004-2 is effective for financial statements for periods ending after December 15, 2004; earlier application is encouraged.</p> <p>For OPEB transactions, the provisions of GASB Technical Bulletin 2004-2 should be applied simultaneously with the requirements of Statement 45.</p>

Accounting Year In Review: 2004

A Financial Reporting letter



For More Information

If you would like further information or to discuss the implications of the matters discussed in this Financial Reporting Letter, please contact the BDO Seidman engagement partner serving you or one of the following partners: Ben Neuhausen or Wayne Kolins.

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Material discussed in this *Financial Reporting* letter is meant to provide general information and should not be acted upon without first obtaining professional advice appropriately tailored to your individual facts and circumstances.

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