



Financial Reporting

Contents:

New Commission Rules and Initiatives	2
Deferral of Internal Control Reporting	2
Deferral of Acceleration of Periodic Report Filing Dates	3
45-Day Extension for Filing Internal Control Reports	3
Expanded and Accelerated Form 8-K Reporting	4
Public Release of Comment Letters	5
Asset-Backed Securities	5
Proposed Rules	6
Securities Offering Reform	6
First-Time Application of IFRS	7
Use of Form S-8 and Form 8-K by Shell Companies	7
XBRL Voluntary Reporting Program	8
Commission and Staff Guidance	8
Internal Control Reporting FAQ	8
Form 8-K FAQ	9
Independence FAQ	10
Applying PCAOB Auditing Standard No. 1	11
SAB 105	11
SAB 106	12
PCAOB Developments	12
Framework for Evaluating Internal Control Deficiencies	12
For Further Information	12

SEC Year in Review

Significant 2004 Developments

Much of the Securities and Exchange Commission's agenda in 2003 was focused on writing the rules required by the Sarbanes-Oxley Act. In 2004, the Commission and its staff devoted great attention to implementing those rules.

Much of the attention was focused on implementing the internal control reporting requirements under Section 404 of the Act. In June, the Commission approved the standard issued by the Public Company Accounting Oversight Board (PCAOB) for audits of internal control, Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* (AS 2). The SEC and PCAOB staffs concurrently released Frequently Asked Questions (FAQ) documents covering internal control reporting by registrants and related auditing requirements. Both FAQs have subsequently been updated to provide additional guidance.

As the year progressed, SEC concerns about the ability to implement the internal control reporting requirements prompted initiatives to allow issuers and auditors more time to comply with the rules.

Implementing the Act also drove the Commission to substantially increase the size of its staff in the Division of Corporation Finance and the Office of the Chief Accountant. The Division of Corporation Finance staff was increased to perform the enhanced reviews of periodic reports filed by registrants under the Securities Exchange Act of 1934, as required by Section 408 of the Act. The Office of the Chief Accountant expanded its staff in part to meet its increased oversight responsibilities resulting from the creation of the PCAOB.

The Commission also completed a rulemaking initiative that was responsive to the real time disclosure goals of Section 409 of the Act by expanding and

Financial Reporting

accelerating the reporting requirements under Form 8-K, the form that is used to report significant current events.

In view of the enhanced regulation and SEC staff scrutiny of 1934 Act reports provided by the Sarbanes-Oxley Act, the Commission feels that greater reliance can be placed on these reports in regulating securities offerings by repeat issuers. Accordingly, in October, the Commission proposed reforms to the securities offering process under the Securities Act of 1933. The proposed reforms would also modernize the process so market participants can take advantage of new technologies.

During 2004 the Commission also addressed important matters other than implementing the Sarbanes-Oxley Act. It adopted rules covering a subject it had sought to address for several years: the registration, disclosure and reporting requirements for issuers of asset-backed securities. Also, in response to a dramatic increase in third-party Freedom of Information Act requests for copies of SEC staff comment letters and registrant responses, the Commission adopted a policy of making those letters publicly available on its website.

The Commission also made other important rule proposals. Foreign private issuers in the European Union will be required to adopt International Financial Reporting Standards in their 2005 financial years. The Commission proposed rules that would provide relief to these issuers by allowing them to provide two years of audited financial statements instead of the currently required three years. In addition, the Commission proposed rules designed to strengthen the registration and reporting requirements for shell companies and undertook

an initiative to consider the benefits of providing tagged data in Commission filings.

The Commission and its staff also provided guidance on a number of matters, including implementing the new internal control and Form 8-K reporting requirements, applying the SEC's auditor independence rules, and applying a new PCAOB auditing standard that requires references to PCAOB standards instead of generally accepted auditing standards. Also, the Commission staff issued two new Staff Accounting Bulletins.

Looking forward to 2005, the Commission can be expected to continue to focus on issuers' implementation of the rules it adopted in response to the Sarbanes-Oxley Act and finalizing the rulemaking proposals outlined in this letter. Also, the Commission staff is working on two projects that could draw significant attention in 2005:

1. Pursuant to Section 401 of the Sarbanes-Oxley Act, the staff is completing a study of issuers' filings to determine the extent of off-balance sheet transactions and whether current accounting standards result in financial statements that reflect the economics of such transactions in a transparent fashion. It is conceivable that this study could raise issues related to the current accounting for operating leases and pension funds.
2. The other project consists of a consideration of the methods companies use to evaluate the materiality of known misstatements of their financial statements. Two methods are used in practice: the "rollover" method and the "iron curtain" method. The staff is concerned about the inconsistency in reporting this creates, as well as

obstacles to correcting misstatements that the rollover method sometimes creates. The staff has said that it plans to address this issue in 2005. If it does, the effects could be significant, and transition could be controversial.

This letter summarizes the 2004 Commission and staff activities described above. We discuss rule-making initiatives finalized in 2004 first, followed by those still in the proposal stage as of December 31, 2004. Although not the focus of this letter, we also briefly discuss 2004 rulemaking and interpretive activities of the PCAOB and its staff.

New Commission Rules and Initiatives

Deferral of Internal Control Reporting (Release 33-8392)

In February, the SEC deferred the dates by which issuers must begin reporting on the effectiveness of internal controls. For companies that are "accelerated filers" (generally U.S. companies that have an equity market capitalization of over \$75 million and have filed an annual report with the Commission), the effective date was deferred until annual reports for fiscal years ending on or after November 15, 2004 (the original date was June 15, 2004.) Thus, accelerated filers with fiscal years ending in the June through October timeframe were given another year before they are required to report on internal controls. The SEC also deferred the effective date for other issuers (including small business issuers and foreign private issuers), which must begin reporting on internal controls in annual reports for fiscal years ending on or after July 15,

2005. (The original date was April 15, 2005.)

The Release is available on the SEC's website (www.sec.gov/rules/final/33-8392.htm).

Deferral of Acceleration of Periodic Report Filing Dates (Release 33-8507)

In November, the Commission adopted rules that postpone for one year the final phase-in of accelerated filing deadlines for reports on Forms 10-K and 10-Q by accelerated filers.

Under the amended rules, the deadline for an accelerated filer to file its annual report on Form 10-K for its fiscal year ending on or after December 15, 2004 remains at 75 days after fiscal year-end. The deadline for the three subsequently filed quarterly reports on Form 10-Q remains at 40 days after quarter-end. The accelerated filing phase-in will resume for annual reports for fiscal years ending on or after December 15, 2005, when an accelerated filer will have to file its annual report within 60 days after fiscal year-end and file its subsequent quarterly reports within 35 days after quarter-end. This will complete the phase-in, and these deadlines will remain in place for all subsequent periods. The revised phase-in schedule for accelerated filers is shown in Table 1.

The rules also make conforming amendments to Regulation S-X to apply the postponed phase-in period to the financial information

updating requirements in other Commission filings, such as registration and proxy statements. In addition, the rules make conforming changes to the deadlines for transition reports.

The amendments were adopted to allow additional time for accelerated filers and their auditors to effectively comply with the internal control reporting requirements of Section 404 of the Act. They do *not* change the requirement for companies to comply with Section 404 this year; they merely give companies additional time to do so.

The Release is available on the SEC's website (www.sec.gov/rules/final/33-8507.htm).

45-Day Extension for Filing Internal Control Reports (Release 34-50754)

Also in November, the SEC issued an exemptive order to provide certain accelerated filers up to 45 additional days to provide management reports on internal control and the related auditors' reports in their annual reports on Form 10-K. An accelerated filer generally must include these reports in its Form 10-K for fiscal years ending on or after November 15, 2004. The extension effectively exempts eligible companies from the requirements of Exchange Act Rule 13a-1 and 15d-1 to include these reports in their annual reports within the 75-day period specified in Form 10-K. The order does not defer the required fil-

ing date for the rest of the annual report.

The deferral is available to accelerated filers that (i) have fiscal years ending between and including November 15, 2004 and February 28, 2005, and (ii) had a public equity float of less than \$700 million at the end of their second fiscal quarter in 2004. The following additional conditions must also be met:

- The Form 10-K must be filed with all required information except the internal control reports within 75 days after the company's fiscal year-end (or within 90 days if a notification is filed pursuant to Exchange Act Rule 12b-25);
 - The company must identify in the Form 10-K the information that has not been filed as permitted by the exemption;
 - If the company has identified a material internal control weakness, or the auditor has identified a material weakness and communicated it to the company, the company must disclose this information in the filing; and
 - The internal control reports must be filed within 45 days after the original 75-day due date by filing an amended Form 10-K. A company that has filed a late Form 10-K pursuant to Rule 12b-25 must still file the required internal control reports within 45 days after the original 75-day due date.
- For purposes of Form S-2 and S-3 eligibility, an accelerated filer relying on this exemption will not be

Table 1 – Phase-in Date for Accelerated Filers

For Fiscal Years Ending On or After	Form 10-K Deadline	Subsequent Form 10-Q Deadline
December 15, 2002	90 days after fiscal year-end	45 days after fiscal quarter-end
December 15, 2003	75 days after fiscal year-end	40 days after fiscal quarter-end
December 15, 2004	75 days after fiscal year-end	40 days after fiscal quarter-end
December 15, 2005	60 days after fiscal year-end	35 days after fiscal quarter-end

Financial Reporting

considered to have timely filed its Form 10-K until it has filed the Form 10-K amendment that includes the internal control reports. The SEC staff has stated that during the 45-day period, companies may file registration statements on Form S-8 and selling security holders may rely on Rule 144.

The PCAOB also adopted a temporary rule, which was approved by the SEC, that permits the delayed filing of auditors' internal control reports consistent with the SEC's order.

The Exemptive Order is available on its website (www.sec.gov/rules/exorders/34-50754.htm). The PCAOB's temporary rule is available on its website (http://www.pcaobus.org/Rules_of_the_Board/Documents/Docket_016/Release2004-014.pdf).

Expanded and Accelerated Form 8-K Reporting (Releases 33-8400 and 33-8400A)

In March, the SEC adopted amendments to the Form 8-K reporting requirements. The changes, which took effect August 23, 2004, encompass the following:

- Expanded disclosure – Eight new reportable events were added to Form 8-K, the disclosure requirements for two existing Form 8-K items were expanded, and two items were transferred, in part, from Forms 10-K/10-KSB and 10-Q/10-QSB to Form 8-K.
- Accelerated due date – The previous five-business day and 15 calendar day filing deadlines were shortened to four business days after a reportable event. The four-business day deadline applies to all of the new reportable events.
- Reorganization – The instructions to Form 8-K were reorganized

into topical categories with a new numbering system.

The revised rules apply to all domestic issuers, including small business issuers. The eight new disclosure items are:

- Item 1.01 – Entry into a Material Definitive Agreement
- Item 1.02 – Termination of a Material Definitive Agreement
- Item 2.03 – Creation of a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement
- Item 2.04 – Triggering Events That Accelerate or Increase a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement
- Item 2.05 – Costs Associated with Exit or Disposal Activities
- Item 2.06 – Material Impairments
- Item 3.01 – Notice of Delisting or Failure to Satisfy a Continued Listing Rule or Standard; Transfer of Listing
- Item 4.02 – Non-reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review

The rules require expanded disclosure for the following two existing Form 8-K items:

- Item 5.02 – Departure of Directors or Principal Officers; Election of Directors; Appointment of Principal Officers (formerly Item 6 – resignation of directors)
- Item 5.03 – Amendments to Articles of Incorporation or Bylaws; Change in Fiscal Year (formerly Item 8 – change in fiscal year)

The two disclosure items transferred, in part, from the periodic reports are:

- Item 3.02 – Unregistered Sales of Equity Securities
- Item 3.03 – Material Modifications to Rights of Security Holders

The rules provide a limited safe harbor from Exchange Act liability under Section 10(b) and Rule 10b-5 for failure to timely file all of the new Form 8-K items except for Item 3.01 (regarding delisting matters) and Item 4.02(b) (regarding notification by a company's independent accountants that a previously issued audit report or completed interim review should not be relied upon). The safe harbor extends only until the company's periodic report covering the period in which the event occurred is due and does not relieve a company of any other disclosure obligation it may have. The safe harbor also does not protect a company if it makes material misstatements or omissions in a Form 8-K filing. The rules provide that the late filing of a Form 8-K with respect to the events to which the safe harbor applies will not affect a company's eligibility to file a short form registration statement on Form S-2 or S-3. However, a company must be current in its Form 8-K filings with respect to these items at the time of a Form S-2 or S-3 filing.

The Commission also amended Securities Act Rule 144 to provide that a company's failure to timely file a Form 8-K report does not affect a security holder's ability to rely on Rule 144 to resell securities.

The releases are available on the SEC's website (<http://www.sec.gov/rules/final/33-8400.htm> and <http://www.sec.gov/rules/final/33-8400a.htm>). See our August 2004 *Financial Reporting* letter (http://www.bdo.com/about/publications/assurance/FRL_Aug_5.pdf) for further details. In November, the SEC staff issued an FAQ document containing guidance on applying these new rules. That FAQ is discussed later in this letter.

Public Release of Comment Letters

In June, the SEC announced that it will make all SEC comment letters and company responses publicly available. The SEC will post the comment letters and company responses on its website (at www.sec.gov) and will also make the documents available to third party service providers to load into their databases. The SEC's decision to publicly release these documents was in response to a dramatic increase in third-party Freedom of Information Act (FOIA) requests for such information.

Timing – The SEC will release comment letters and response letters relating to filings made after August 1, 2004 that are selected for review. In determining which filings fall after August 1, 2004, the SEC will look to the filing that is the primary focus of the review. For example, if the SEC selects for review a Form 10-K filed before August 1, 2004, and in connection with that inquiry also reviews a Form 10-Q filed after August 1, 2004, the determination will be based on the filing date of the Form 10-K. Similarly, for documents that were originally filed before August 1, 2004 but were amended after this date, the determination will be made based on the earlier filing date. The letters are not yet available. They will become accessible when the SEC staff completes the necessary technical modifications to the SEC's EDGAR system.

After the new process is implemented, correspondence will be released not less than 45 days after the SEC has completed a filing review. As part of implementing this process, the SEC staff will begin a new practice of telling registrants when all comments on Exchange

Act filings are resolved and reviews are complete.

Confidential Treatment – A company may seek to have the SEC withhold sensitive portions of its written response to an SEC comment letter by making a request under Rule 83 of the SEC's Rules of Practice. That rule requires the company to submit two separate versions of its response letter: a letter without the confidential information (the "redacted" version) and a separate paper document that includes the information for which confidential treatment is requested. The SEC plans to release only the redacted version of the response (although it will continue its practice of questioning requests for confidential treatment that on their face are overly broad).

Someone seeking release pursuant to the FOIA of the redacted portions of a response letter must submit a FOIA request for the information. At that time, the Commission will process the information request, and the company may need to defend its request for confidential treatment.

A list of the type of information that is exempt from release under the FOIA can be accessed at www.sec.gov/foia/nfoia.htm. Procedures for requesting confidential treatment can be accessed at www.sec.gov/foia/confreat.htm. Registrants should consult with legal counsel in addressing confidential treatment issues.

"Tandy" Representation Required – In the past, the SEC staff has requested that certain companies under review provide a "Tandy" letter, in which the company represents that it will not use the SEC's comment process as a defense in any securities litigation against it. Since all comment letters and responses will now be made publicly available, the SEC will request

that all companies whose filings are reviewed provide such representations. The SEC has stated that this request and representation should not be construed as confirming that there is or is not, in fact, an inquiry or investigation or other matter involving the company.

The SEC's announcement of this new policy is available on the SEC's website (<http://www.sec.gov/news/press/2004-89.htm>).

Asset-Backed Securities (Release 33-8518)

In December, the SEC adopted new and amended rules and forms to address the registration, disclosure and reporting requirements for issuers of asset-backed securities under the Securities Act of 1933 and the Securities Exchange Act of 1934.

Asset-backed securities (ABS) are defined in the new rules as securities that are backed by discrete pools of financial assets that convert to cash according to their terms. Issuers of ABS typically are passive entities (most often trusts), created for the limited purpose of acquiring the underlying assets and issuing ABS. Many of the reporting and disclosure requirements for operating company issuers do not fit well with the information that is material for most ABS issuers. To address the differences, the SEC's Division of Corporation Finance has over the years provided informal guidance to ABS issuers through the staff comment process, no action letters and interpretations. The SEC believes that the ABS rules will increase transparency and efficiency for this market.

The new rules seek to accomplish the following objectives:

- Update and clarify the registration requirements for ABS, including expanding the types of ABS that

Financial Reporting

may take advantage of the benefits of delayed “shelf” or short-form registration on Form S-3;

- Consolidate and codify the interpretive positions that have allowed modified periodic reporting that is more suitable for ABS issuers;
- Provide tailored disclosure guidance and requirements for registration and periodic reporting by ABS issuers; and
- Streamline and codify existing interpretive positions that permit the use of written communications in a registered offering of ABS in addition to the registration statement and prospectus.

The new ABS rules will apply to any offering of asset-backed securities after December 31, 2005.

The release is available on the SEC’s website (<http://www.sec.gov/rules/final/33-8518.htm>).

Proposed Rules

Securities Offering Reform (Release 33-8501)

In October, the SEC proposed reforms to modernize the securities offering process under the Securities Act of 1933. The proposed changes are designed to encourage (rather than chill) communications to investors during an offering. They also would change the SEC’s approach to regulating offerings by placing greater reliance on reports filed periodically under the 1934 Act. The Commission feels that greater reliance on 1934 Act reports is appropriate in view of the enhanced regulation and SEC staff scrutiny of these reports provided by the Sarbanes-Oxley Act.

The primary focus of the proposed reforms is on three aspects of the offering process: (i) communications during registered securities offerings, (ii) the registration process,

and (iii) the delivery of final prospectuses to investors. Certain additional disclosures would be required in annual reports filed with the Commission.

The proposed changes would grant more flexibility to issuers. The rules would grant the greatest amount of flexibility to a new category of issuers to be called “well-known seasoned issuers.” A well-known seasoned issuer would be one that (i) is eligible to register a primary offering of its securities on Form S-3 or Form F-3 and (ii) has either \$700 million of public common equity float or has issued \$1 billion of registered debt securities in the preceding three years.

Communications during Registered Securities Offerings – The proposed reforms would relax the “gun-jumping” and “quiet period” provisions related to registered offerings. These provisions restrict communications by a company that is conducting a securities offering until the SEC declares the registration statement effective. The degree to which these provisions would be relaxed would vary depending on the type of issuer:

- Well-known seasoned issuers would be permitted, subject to conditions, to engage at any time in oral and written communications, including the use at any time of a new type of written communication called a “free writing prospectus” (i.e., a written offer outside of the statutory prospectus);
- All other issuers and offering participants would be permitted, subject to conditions, to use a free writing prospectus after a registration statement is filed;
- Communications more than 30 days before the filing of a registration statement would be

allowed so long as they did not reference the offering; and

- The types of communications that constitute an offering for which a statutory prospectus must be filed would be narrowed.

In some cases, the rules would require that a free writing prospectus be filed with the SEC. Companies would still be liable under the securities laws for material misstatements or omissions in communications about an offering.

These proposed changes would not be available to blank check companies, penny stock issuers, shell companies, financially troubled companies, investment companies, business development companies, or merger and acquisition transactions.

Registration Process – Most of the proposed changes in the registration process are aimed at streamlining the shelf registration process. Under the current rules for shelf registration, an issuer can register an offering of securities that will be made on a delayed or continuous basis (in contrast to an offering that will commence immediately and be completed within a short period of time). After the SEC staff declares a registration statement effective, the securities can generally be taken “off the shelf” and offered without further clearance by the SEC staff. The proposed reforms would streamline the process in the following ways:

- For well-known seasoned issuers, a more flexible version of shelf registration, referred to as “automatic shelf registration,” would be established. Registration statements filed under the automatic shelf registration process would be automatically effective (without SEC staff review). The process would also permit pay-as-you-go registration fees and provide more flexibility regarding the amounts

and classes of securities that can be included in a single shelf registration;

- Immediate takedowns of securities covered by shelf registration statements would be permitted;
- The current requirement applicable to certain shelf registrations that an issuer register only securities it intends to sell within a two-year period would be replaced by a requirement to file an updated registration statement every three years;
- Currently, if there are material changes to the plan of distribution described in the base prospectus (the prospectus included in the effective registration statement), a post-effective amendment must be filed. Under the proposal, issuers would be permitted to disclose such changes through a prospectus supplement; and
- For seasoned issuers (those eligible to use Form S-3 or F-3), the identity of the selling security holders in secondary offerings could be provided in a prospectus supplement (rather than in a post-effective amendment).

In addition, the rules would be modified to codify in a single rule the information that may be omitted from a base prospectus in a shelf registration statement at effectiveness and provided later via a prospectus supplement.

The proposed changes would also streamline the registration process for repeat issuers conducting offerings on Forms S-1 and F-1. These forms would be amended to permit issuers to incorporate previously filed Exchange Act reports by reference. Forms S-2 and F-2 would be eliminated.

Delivery of Final Prospectuses to Investors – The SEC proposes to mod-

ernize the prospectus delivery process by creating an “access equals delivery” model. Under the proposed model, the filing of a final prospectus with the SEC and complying with other conditions would satisfy the final prospectus delivery requirements. Issuers would not have to print and deliver final prospectuses.

To preserve an investor’s ability to trace securities to a registered offering, the proposals include a separate requirement to notify investors that they purchased securities in a registered offering.

Additional Disclosures in Exchange Act Reports – The proposals would require the following additional disclosures in Exchange Act periodic reports:

- Disclosure of risk factors in Form 10-K;
- Disclosure of an issuer’s status as a voluntary filer of Exchange Act reports; and
- For accelerated filers, disclosure in Form 10-K of unresolved comments from the SEC staff that the issuer believes are material and that are more than 180 days old.

The release is available on the SEC’s website (www.sec.gov/rules/proposed/33-8501.htm).

First-Time Application of IFRS (Release 33-8397)

In March, the SEC proposed amendments to Form 20-F that would provide relief to foreign private issuers that change their basis of accounting to International Financial Reporting Standards (IFRS). (Foreign private issuers in the European Union will be required to adopt IFRS in their 2005 financial years.) The rules would allow those companies, for their first year of reporting under IFRS, to provide two years of audited financial statements instead of the currently required three years

in a registration statement or annual report filed on Form 20-F. The proposed rules would apply to companies that publish IFRS financial statements for the first time for any financial year beginning no later than January 1, 2007. As proposed, the relief would apply only to issuers who fully apply IFRS. Issuers who adopt the European Union’s modification of IFRS for financial instruments would be required to provide three years of audited financial statements.

Regardless of the year in which a foreign private issuer adopts IFRS, the proposed amendments would require the company to provide disclosure related to exceptions from IFRS on which it relied. The proposed amendments would also clarify the level of information required in the reconciliation from a company’s previous basis of accounting to IFRS.

The Release is available on the SEC’s website (www.sec.gov/rules/proposed/33-8397.htm).

Use of Form S-8 and Form 8-K by Shell Companies (Release 33-8407)

In April, the Commission proposed amendments to its rules that would apply to public shell companies. The proposed amendments would:

- Prohibit shell companies from using Form S-8 to register offerings of securities. Form S-8 is the form used by public companies to register offerings in connection with employee benefit plans under the Securities Act of 1933. A company that ceases to be a shell company would be allowed to use Form S-8 to register securities 60 days after it has filed information equivalent to the information required when registering a class of securities under

Financial Reporting

the Exchange Act of 1934 on Form 10 or Form 10-SB.

- Require a public shell company, when obligated to report an event on Form 8-K that causes it to cease being a shell company (e.g., the acquisition of an operating company), to include in that Form 8-K the same type of information as it would be required to file to register securities on Form 10 or Form 10-SB. The information would be required within four days of the acquisition. The 75-day time period available for filing acquired business financial statements would not be available.

The amendments would define the term “shell company” to mean a company with no or nominal operations, and with no or nominal assets or assets consisting solely of cash and cash equivalents. The definition would include foreign private shell companies. However, the Commission has solicited comments on the manner in which these companies should report the information that a domestic shell company would be required to report on Form 8-K.

The release is available on the SEC’s website (www.sec.gov/rules/proposed/33-8407.htm).

XBRL Voluntary Reporting Program (Releases 33-8496 and 33-8497)

In September, the SEC proposed rule amendments and issued a concept release as part of an initiative to consider the benefits of tagged data and its potential for improving the timeliness and accuracy of analysis of financial disclosure in Commission filings. The proposed rules would establish a voluntary program allowing registrants to file supplemental financial information using eXtensible Business Reporting

Language (XBRL). XBRL is a reporting language developed by an international non-profit consortium of approximately 250 major companies, organizations and government agencies. XBRL uses Extensible Mark-up Language (XML) to standardize and tag financial information.

If adopted, the program would begin in early 2005 for the 2004 calendar year-end reporting season.

Under the proposed program, registrants would be able to voluntarily furnish certain financial data from a related Exchange Act or Investment Company Act filing as an exhibit in XBRL format. The exhibit could be furnished either with the filing or with a Form 8-K or 6-K that references the related filing. The XBRL documents would not be considered “filed” and would not be incorporated into other SEC filings.

In its related concept release, the Commission solicited public comment on the benefits of tagging data; the implications of tagging data not only for filers but also for investors, the SEC and other market participants; and the adequacy and usefulness of XBRL as a format for reporting financial information.

The proposing release and the concept release are available on the SEC’s website (<http://www.sec.gov/rules/proposed/33-8496.htm> and <http://www.sec.gov/rules/concept/33-8497.htm>).

Commission and Staff Guidance

Internal Control Reporting FAQ

In June, shortly after the release of AS 2, the SEC and the PCAOB staffs concurrently released FAQ documents covering AS 2 and Section 404 internal control reporting requirements. Both FAQs were

updated in October; the PCAOB staff’s FAQ was further updated in December.

Some of the more common registrant reporting issues covered in the SEC staff’s FAQ are discussed below.

Requirements related to entities consolidated pursuant to FASB Interpretation 46(R) (VIEs) and EITF 00-1 (proportionate consolidation) – Question 1 communicates that management’s internal control report must include all consolidated entities, irrespective of the basis for consolidation. However, management may exclude the following entities from its evaluation if it does not have the ability, in practice, to assess their controls:

- Entities in existence prior to December 15, 2003 and consolidated pursuant to FIN 46; and
- Entities consolidated pursuant to EITF 00-1.

If such entities are excluded from a company’s internal control evaluation, the company should disclose this fact in management’s report on internal control and refer to a separate scope discussion that discloses the size of the entities excluded and explains why they were excluded.

Requirements related to equity method investees – The staff communicated in Question 2 that a company is not required to evaluate the internal controls of its equity method investees. This guidance applies regardless of the significance of the equity method investee to the registrant.

Requirements regarding recently purchased businesses – Question 3 communicates that an internal control evaluation of a purchased business may be deferred until the year after the acquisition. Although the staff’s response to question 3 states that the evaluation may be deferred in instances where a current assessment is not “possible,” the staff has stated that it “will likely not object

to anyone who decides to use this relief in the year of acquisition.” When a recently acquired business is excluded from the internal control evaluation, a company should disclose the following in its annual report:

- The identity of the acquired business;
- The fact that the entity was excluded from the scope of management’s evaluation of internal control; and
- The significance of the entity to the issuer’s consolidated financial statements.

Questions 3 and 9 communicate that after a business combination, a registrant may defer reporting material changes in internal control (pursuant to Item 308(c) of Regulation S-K) that result from the fact that the registrant’s internal controls now also encompass the acquired business’ internal controls. Registrants may defer such reporting until the annual report that includes the first assessment of the controls of the acquired business.

Conclusions on effectiveness of internal control over financial reporting – Question 5 communicates that management may not qualify its conclusions in its report on effectiveness of the issuer’s internal control over financial reporting.

Question 4 communicates that a management or auditor conclusion that an issuer’s internal controls are not effective does not affect the issuer’s timely/current filer status for purposes of Rule 144 and Forms S-2, S-3, and S-8 eligibility as long as:

- The report that includes the assessment is timely filed;
- The auditor’s report on the financial statements is unqualified; and
- All other reporting obligations are timely satisfied.

Changes in controls pursuant to Regulation S-K Item 308(c) – Item 308(c) requires registrants to disclose material changes in internal controls in periodic reports. However, question 9 communicates that the SEC staff will not object if a registrant does not disclose such changes made in preparation for the registrant’s first management report on internal control over financial reporting. However, the staff stated that if the registrant identifies a material weakness, it should carefully consider whether it should disclose that fact as well as changes made in response to the material weakness.

Controls over third party service providers – Question 14 communicates that management is responsible for maintaining and evaluating controls over the flow of information to and from service providers. Management may rely on a Type 2 SAS 70 report (i.e., a service organization’s auditor’s report on the design and effectiveness of controls placed in operation at the service organization) in assessing controls of the service provider, even if auditors for both companies are the same. However, if the registrant engages its own audit firm to prepare a SAS 70 report on a service provider, it may not rely on the report for purposes of assessing internal controls.

Question 14 also communicates that management may rely on a SAS 70 report for a service provider that is as of a different year-end than the issuer.

Effective date – Question 7 communicates that the effective date for complying with the SEC’s rules on Section 404 reporting for accelerated filers (i.e., fiscal years ending on or after November 15, 2004) applies in 2004 to new accelerated filers (i.e., a company with a public

float that exceeded \$75 million for the first time as of the end of the second quarter of 2004).

Other Issues – Question 22 communicates the SEC staff’s view that, even though not technically required, glossy annual reports that accompany proxy statements should include management and auditor reports on internal control.

The SEC staff’s FAQ document is available on the Commission’s website (<http://www.sec.gov/info/accountants/controlfaq1004.htm>), and the PCAOB staff’s FAQ document is available on the PCAOB’s website (a link is provided at: http://www.pcaobus.org/Standards/Staff_Questions_and_Answers/index.asp).

Form 8-K FAQ

In November, the SEC staff released an FAQ document containing guidance on applying the new Form 8-K disclosure requirements that became effective August 23, 2004. The FAQ addresses 30 questions.

About one half of the questions concern Items 1.01 and 1.02 of Form 8-K (entry into or termination of a material agreement). Several questions on material agreements address disclosure requirements related to officer and director employment agreements, equity compensation arrangements and cash bonus awards.

Some of the more common reporting issues covered in the FAQ include:

- *Reporting triggering events on periodic reports* – The staff clarified that a Form 8-K triggering event that occurs within 4 business days before a registrant’s filing of a periodic report on Form 10-Q, 10-QSB, 10-K or 10-KSB may be disclosed in that periodic report rather than on Form 8-K. Two exceptions to this are triggering

Financial Reporting

events under Item 4.01, Changes in Registrant's Certifying Accountants, and Item 4.02, Non-Reliance on Previously Issued Financial Statements or Related Audit Report or Completed Interim Review. These two events must be reported on Form 8-K.

- *Triggering events that apply to a registrant's subsidiaries* – The staff clarified that all triggering events on Form 8-K apply to a registrant's subsidiaries if the event is material to the registrant.
- *Item 1.01, Entry into a Material Definitive Agreement* – The staff clarified that an agreement that was not material when the registrant entered into it does not have to be disclosed under Item 1.01 if it later becomes material, unless it becomes material concurrent with an amendment to the agreement. In any event, the registrant must file the agreement as an exhibit to the periodic report relating to the period in which the agreement becomes material.
- *Item 2.05, Costs Associated with Exit or Disposal Activities* – The staff clarified that costs associated with an exit activity that must be disclosed under Item 2.05 are not limited to the costs addressed by FASB Statement 146, *Accounting for Costs Associated with Exit or Disposal Activities*. Other costs that may need to be disclosed include those addressed by FASB Statements 87, 88, 106 and 112. The staff also clarified that when a registrant plans to terminate employees under an exit plan, it need not disclose the termination plan until it has informed affected employees.
- *Item 4.02, Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review* – The FAQ states that if a

registrant has filed a Form 8-K under Item 4.02(a) to report its determination that its financial statements should no longer be relied on, it need not file a second Form 8-K to indicate that its auditor has also concluded that future reliance should not be placed on its audit report, unless the auditor's conclusion relates to an error or matter different from that which triggered the registrant's filing under Item 4.02(a). This guidance is intended to address the fact pattern where a registrant decides that disclosure is necessary and the auditor subsequently informs the registrant that it agrees with that conclusion. The auditor's agreement with management's conclusion does not trigger a filing requirement under Item 4.02(b). On the other hand, if the auditor concludes that management has not made the disclosure it believes is necessary and informs management of the need to prevent further reliance on its report, a report under Item 4.02(b) is required.

- *Item 5.02, Departure of Directors or Principal Officers; Election of Directors* – The staff clarified that a registrant's decision not to nominate a director for re-election does not trigger a disclosure requirement under Item 5.02 unless the director, upon receiving notice that he or she will not be nominated, then resigns or refuses to stand for re-election. The staff also clarified that a registrant may delay disclosure under Item 1.01, Entry into a Material Agreement, of an employment agreement with a newly appointed officer until the time a public announcement of the appointment is made, consistent with the permitted delay under Item 5.02(c).

The FAQ document is available on the SEC's website (www.sec.gov/divisions/corpfin/form8kfaq.htm).

Independence FAQ

In December, the SEC staff updated its list of frequently asked questions on topics related to auditor independence. The new FAQ adds guidance to that provided in 2003 and 2001 and updates some of the staff's previous answers. The following are highlights of the new guidance concerning auditor independence:

Audit Partner and Partner Rotation

- Question 8 communicates that a lead or concurring partner, after rotating off a public company audit engagement, may not provide services to the company in a specialty partner capacity (i.e. providing tax services or national/technical services) during his or her required time out period. However, limited discussions solely between the engagement team and a rotated-off partner generally would be permissible.
- Question 9 communicates that when the principal auditor of a public company refers to and places reliance on the auditor of a subsidiary or equity method investee, the partner rotation requirements are applicable to the auditors of these entities. The principal auditor is primarily responsible for monitoring the other firm's compliance with the independence rules.
- Question 10 communicates that a partner who is primarily responsible for the audit of internal control over financial reporting of a public company is subject to the same partner rotation requirements as the audit partners who participated in the audit of that company's financial statements.

Other Matters

- Question 3 communicates that the SEC's independence rules apply to audits of financial statements required by Regulation S-X Article 3, including financial statements of entities other than those of the issuer. However, these requirements do not apply to financial statements required by Regulation S-X Rules 3-05 (businesses acquired or to be acquired) and 3-14 (real estate operations to be acquired.)
- Question 4 reconfirms the staff's long-held view that an agreement that provides for indemnification by the client of an auditor impairs the independence of the auditor. Further, including a clause in engagement letters that the issuer would release, indemnify or hold harmless from any liability and costs resulting from knowing misrepresentations by management also would impair the auditor's independence.

Fee Disclosures

- Question 5 updates Question 10 of the January 2001 FAQ by reminding registrants that domestic companies must include audit fee disclosures in Form 10-K or 10-KSB if they do not issue proxy statements that include the fee disclosures.

The FAQ document is available on the SEC's website (<http://www.sec.gov/info/accountants/ocafaqaudind121304.htm>).

Applying PCAOB Auditing Standard No. 1 (Release 33-8422)

In May, the SEC approved PCAOB Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board* (AS 1). AS 1 directs auditors to refer to the "standards of the Public Company Accounting Over-

sight Board (United States)" in lieu of references to generally accepted auditing standards (GAAS) in audit reports relating to financial statements of issuers.

The SEC issued an interpretive release concurrent with its release approving AS 1 to clarify the impact of the standard on certain SEC rules and federal securities laws that refer to GAAS. The interpretive release clarifies the following:

- References in SEC rules and staff guidance and in the federal securities laws to GAAS, as they relate to issuers, should be understood to mean the standards of the PCAOB plus any applicable rules of the SEC. The SEC intends to codify this interpretation.
- Although the PCAOB has stated that AS 1 supersedes references to GAAS, the standard does not supersede the SEC's rules. The PCAOB has specifically provided that its rules do not supersede the SEC's rules. Therefore, registered public accounting firms must comply with the more restrictive of the SEC's or the PCAOB's rules (for example, with respect to the SEC's independence rules, which are more restrictive than the PCAOB's independence rules).
- If a registrant incorporates by reference a report previously filed with the SEC, the report would not need to include the otherwise required reference to the standards of the PCAOB.

The interpretive release is available on the SEC's website (www.sec.gov/rules/interp/33-8422.htm).

SAB 105

In March, the Commission's staff issued Staff Accounting Bulletin (SAB) 105. The SAB addresses the accounting for loan commitments accounted for as derivatives under

FASB Statement 133, *Accounting for Derivative Instruments and Hedging Activities*.

In SAB 105, the staff indicates that when measuring these derivative instruments, registrants should not recognize a servicing rights asset or any internally developed intangible asset (for example, customer relationships) associated with a loan commitment when the commitment is originated. Recognition of a servicing rights asset is appropriate only if and when the loans are sold with servicing retained. Recognition of an intangible "asset" would only be appropriate in third-party transactions, such as the purchase of loans or loan commitments, individually, in pools, or in a business combination. As a result, no gain should be recorded upon origination of loan commitments. The SAB does not discuss accounting after origination date.

SAB 105 also requires the following disclosures regarding loan commitments accounted for as derivative instruments:

- Accounting policy for mortgage-loan commitments pursuant to APB Opinion 22, *Disclosure of Accounting Policies*;
- Methods and assumptions used to estimate fair value of the loan commitments; and
- Any associated hedging strategies as required by Statement 133.

An issuer should also provide the disclosures required by Regulation S-K regarding market risk (Item 305) and in Management's Discussion and Analysis (Item 303) related to its mortgage-loan commitment derivatives.

This guidance must be applied prospectively to loan commitments accounted for as derivatives entered into subsequent to March 31, 2004.

Financial Reporting

The SAB is available on the SEC's website (www.sec.gov/interps/account/sab105.htm).

SAB 106

In September, the SEC staff released SAB 106, which expresses the staff's views regarding the application of FASB Statement 143, *Accounting for Asset Retirement Obligations*, by oil and gas producing companies that follow the full cost accounting method. The SAB provides guidance related to the following:

- Computing the full cost ceiling in a manner that avoids double-counting the expected future cash outflows associated with asset retirement obligations;
- Required disclosures relating to the interaction of Statement 143 and the full cost rules; and
- The impact of Statement 143 on the calculation of depreciation, depletion, and amortization under the full cost method.

Registrants are expected to apply the accounting and disclosures described in SAB 106 prospectively as of the beginning of the first fiscal quarter beginning after October 4, 2004. Financial statements filed with the SEC before applying the guidance in this SAB should include the disclosures required by SAB 74 (Topic 11-M).

The SAB is available on the SEC's website (www.sec.gov/interps/account/sab106.htm).

PCAOB Developments

During 2004, the PCAOB continued to review the AICPA standards that

it has adopted on an interim basis to determine if those standards should be superseded or amended. In addition to AS 1 and AS 2 discussed previously, the PCAOB adopted a standard for audit documentation, AS 3, *Audit Documentation*, which was approved by the SEC in August. The standard requires that the auditor document the procedures performed, evidence obtained and the conclusions reached so that an experienced auditor (e.g., a member of the PCAOB inspection staff) can understand the auditor's work.

In December, the PCAOB proposed for public comment new ethics and independence rules. Among other provisions, the proposed rules would prohibit a registered public accounting firm from (a) providing certain tax services (related to aggressive tax transactions) to its public company audit clients, (b) providing any tax services to officers in a financial reporting oversight position (e.g., CEO, CFO) or (c) receiving contingent fees from its public company audit clients. In addition, the proposed rules would require specific written and oral communications between a registered firm and its public company audit client's audit committee regarding permitted tax services.

Framework for Evaluating Internal Control Deficiencies

In response to the requirements of AS 2, representatives from nine audit firms, including BDO Seidman,

LLP, and a professor from Georgia State University developed a framework for assessing exceptions and deficiencies that are identified in an evaluation of a company's internal control over financial reporting. The first version of the framework, released in October, covers process/transaction-level exceptions and deficiencies. The framework was subsequently expanded to cover (i) information technology general control deficiencies and (ii) deficiencies in pervasive controls other than information technology general controls.

The PCAOB staff has stated publicly that it considers the framework useful and consistent with AS 2, although the PCAOB believes that there are other ways of evaluating deficiencies.

The framework is available on our website (<http://www.bdo.com/services/assurance/sarbanes/Framework—Version3.pdf>).

For Further Information

If you would like further information or to discuss the implications of these matters, please contact the BDO Seidman, LLP engagement partner serving you or one of the following partners:

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