

[Home](#) | [Previous Page](#)

U.S. Securities and Exchange Commission

Speech by SEC Staff: Current Activities of the Office of the Chief Accountant

Remarks by

Jackson M. Day

*Deputy Chief Accountant, Office of the Chief Accountant
U.S. Securities & Exchange Commission*

Current Activities of the Office of the Chief Accountant

January 8, 2001

The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are those of Mr. Day and do not necessarily reflect the views of the Commission, the Commissioners, or other members of the Commission's staff.

Introduction

Good afternoon. I want to thank you for the opportunity to speak with you today.

Before I move on I must remind you that my comments are my own and may not represent the views of the Commission or its staff.

So, let's get started. Today I am going to talk about the current hot buttons of the Office of the Chief Accountant and then I will give you a peak at our "to do" list for 2001. I'll begin with a review of our hot buttons.

In October 2000, we issued our annual audit risk letter to the AICPA which summarizes many of the issues currently on our radar screen. That document, which is about 30 pages long, gives one a good idea of what is on our mind. It is available on our website at www.sec.gov. If you have not read it, I encourage you to do so. Let me highlight a few of the items in the letter.

The first item I would like to discuss is revenue recognition. As an entire section of this conference is dedicated to this issue, I will spare you from listening to the details twice. However, I would like to make a few points.

SAB 101¹ is now effective for calendar year companies and will be effective for all registrants soon. Watching the implementation of SAB 101 has been interesting. Despite all of its fanfare, less than 2 in 100 registrants reported in the calendar third quarter of 2000 that they had made or expect to make an accounting change under SAB 101. In addition, only 6 out of 100 registrants indicated that they were considering SAB 101 and were not sure of its impact, if any.

As you might suspect, we will be watching how many registrants actually report a change. As a reminder, registrants that have not yet adopted SAB 101 may need to make SAB 74² disclosures until adoption.

In addition, the EITF is or has been addressing several income statement issues related to revenue. Some of those issues, such as gross versus net, build on the guidance in SAB 101. Other EITF issues address matters that were not discussed in SAB 101. The staff is keenly interested in the outcome of all of these EITF issues.

Please allow me the opportunity to elaborate on a couple of the issues I just mentioned. First, gross versus net. I will not go into detail, but I wanted to give you a heads up that the SEC staff generally presumes that net reporting is appropriate when the reporting entity is not in the chain of title or the primary obligor and therefore does not have the risks and rewards of ownership.

Another frequent question relates to the timing of revenue recognition for installation of large equipment. Specifically, the question is whether it is ever appropriate to record 100% of the revenue in a transaction, including revenue for the installation, if the installation has not yet been performed.

For example, Manufacturer sells a large piece of equipment complete with installation to Customer. The installation is not essential to the functionality of the equipment, but is more than inconsequential or perfunctory. Further, the entire fee is due 30 days after delivery of the equipment regardless of whether the installation is performed and no part is subject to refund even if installation is never completed. The equipment is delivered December 15 and installation is completed on January 30. The fair value of the equipment is \$980,000 and the fair value of the installation is \$20,000. Assuming all other revenue recognition criteria have been met, how much revenue can Company A recognize as of December 31-\$980,000 or \$1,000,000? Some believe that it is appropriate to record \$1,000,000 and accrue the costs related to the installation. However, the staff believes that it is only appropriate to recognize \$980,000. This is consistent with the discussion in Question 4 of the Frequently Asked Question (the FAQ) document on SAB 101. A similar conclusion is reached in Scenario C of Example 2 in Appendix A of the FAQ.

The general concept being applied is that the customer is paying for services and the revenues from those services are earned and should be reflected as revenues as the services are performed. Recording the revenues for services rendered at an earlier date merely by accruing the future expected service costs is not representationally faithful to the economics of the transaction.

Now let's shift gears and talk about Statement 133.³ Calendar year companies were required to adopt Statement 133 last week. As a reminder, it is the staff's view that if your hedge documentation has not yet been completed, then hedge accounting is not appropriate until it is finished. The staff recently has received a number of inquiries on Statement 133, including several questions related to disclosures about classification, hedge ineffectiveness, and documentation requirements for hedge accounting. If you are interested in the details you may wish to review the December 4, 2000 speech made by Michael Pierce that is available on our website. In addition, the staff expects auditors to have gained sufficient competent evidential matter about companies conclusions on the assessment of hedge effectiveness, appropriateness of hedge accounting, and valuation of derivatives.

I would like to spend a couple of minutes on future DIG issues. Some have expressed concerns about implementation of Statement 133 in light of the activities of the Derivatives Implementation Group and its process referred to as the DIG. Their concerns include questions as to what instruments are within the scope of Statement 133 and how the transition amounts are to be determined.

For the past two years we have encouraged registrants and their auditors to identify potential issues and submit them to the DIG. Accordingly, we are very supportive of the DIG and its role. We believe the DIG is critical to the process of implementing a standard that addresses transactions as complex as derivatives.

Further, we understand that the DIG may clarify the accounting for certain past transactions that it had not previously or fully addressed. In evaluating the accounting for those transactions, we consider if the rationale for the previous accounting treatment is reasonable and not inconsistent with the intent of Statement 133 and previously resolved DIG issues.

Another issue many registrants will be facing is the implementation of Statement 140.⁴ Calendar companies are reminded that they must satisfy the disclosure provisions of Statement 140 in 2000.

A couple of more points about Statement 140-the first one related to the SPE rules. Registrants are encouraged to strictly apply the new rules for SPEs when they go into effect. On December 4, 2000 David Kane gave a speech on Statement 140. That speech discusses several implementation questions that the staff has answered. If impacted, I encourage you to read that speech, which is available on our website. Finally, don't forget to consider the implications of SAB 74. And, don't forget the guidance in the FASB's Q&A expected out soon.

That wraps up my comments on new guidance. Now, I would like to talk to you about certain aspects of existing guidance.

Paragraph 16 of Statement 115⁵, requires the cost basis of an individual security to be written down to fair value (that is, as a realized loss) even if the decline is other than temporary. That write down should be recognized in earnings.

SAB 59⁶ identifies some factors that should be considered to determine whether a decline in the value of a security is other than temporary. The SAB also states that other than temporary does not mean permanent. SAB 59 essentially requires that a registrant have evidence to support that the amortized cost of a security will be realized. Unless such evidence exists, a write-down accounted for as a realized loss should be recorded.

I also would like to comment on MD&A disclosures to be made during this filing season. Item 303 of Regulation S-K requires a discussion of liquidity, capital resources, results of operations and other information. This disclosure is necessary to gain an understanding of a registrant's financial condition, changes in financial condition and results of operations. In other words, MD&A should "give investors an opportunity to look at the registrant through the eyes of management by providing a historical and prospective analysis of the registrant's financial condition and results of operations, with a particular emphasis on the registrant's prospects for the future."

The staff has seen instances where companies have repeated, in MD&A, the

amounts or disclosures included in the financial statements. The staff also has seen situations where companies have simply computed new amounts derived from those provided in the financial statements.

The staff has concluded that these practices fall short of providing investors with the required disclosures. Registrants are urged to review Financial Reporting Release No. 36⁷, including the examples set forth in that release, which summarized the results of a project to evaluate compliance with MD&A requirements.

MD&A discussions should clearly explain the known trends, demands, events, commitments and uncertainties that are reasonably likely to materially affect a registrant's liquidity, capital resources, and results of operations. In making these disclosures, it is important that the reasons for the trends, demands, events, commitments, and uncertainties are discussed, in addition to quantifying the related effects. With today's volatile markets, I urge you to focus this year on the quality of disclosures within MD&A, especially its forward-looking statements.

Since the effective date of Statement 131⁸, the staff has seen instances in which the MD&A disclosures or press releases of registrants describe business segments that differ from the business segments identified and disclosed in the footnotes to the financial statements. Those cases often lead to questions. While Statement 131 is a disclosure standard, that does not diminish its importance or the level of compliance required by financial statement preparers.

When segment disclosures in the financial statements do not reflect a consistent identification of the registrant's segments as evidenced in the internal and external reports and materials used by the chief operating decision maker, the staff has requested registrants to amend their financial statement filings. That practice is not likely to change.

Now I would like to focus on lending activities. Recent reports from bank regulators indicate that credit risk within some loan portfolios may be increasing. In light of this, financial institutions experiencing this trend need to be particularly mindful of internal controls and processes associated with the allowances for loan losses to ensure timely and appropriate allowance amounts.

The concept in GAAP is that the impairment of loans should be recognized when, based on all available information, it is probable that a loss has been incurred based on past events and conditions existing at the balance sheet date. In other words, registrants should reflect the changes in the credit quality of their loan portfolio in their allowance for loan losses on a timely basis.

As credit quality deteriorates, the allowance should be adjusted upward in a timely fashion to reflect the additional losses that have been incurred. Likewise, as the credit quality of an institution's loan portfolio improves, there should be a corresponding change downward in the amount of the necessary allowance. Simply put, an institution with a higher percentage of troubled loans and an institution with a high credit quality portfolio should have loan loss allowances and provisions that look distinctly different to investors.

Before I move on to our to do list, let me touch on a couple of more items. First, restructurings. I want to remind registrants to carefully consider the

guidance in SAB 100⁹ when recording restructuring charges. In addition, registrants should ensure any subsequent changes in the resulting liability accounts are adequately supported.

Registrants are reminded to ensure that their disclosures about those changes fully comply with the requirements of APB 20¹⁰ for changes in accounting estimates. Paragraph 33 of APB 20 specifically requires registrants to disclose the effect on income and per share amounts for a change that affects several future periods.

Furthermore, as required by Item 303 of Regulation S-K, registrants also should disclose in MD&A changes in accounting estimates that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition.

Let's discuss impairment for a moment. Statement 121¹¹ establishes the guidance for impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used. Paragraph 5 of Statement 121 lists examples of events or changes in circumstances that trigger a review of long-lived assets for impairment. In certain instances, the staff has noted that the triggering event resulting in an impairment charge appears to be a change in senior management. The staff has questioned the timing and appropriateness of impairment charges recorded at the same time as a change in senior management. In particular, the staff has inquired as to the underlying changes in the business and its economics, when those changes occurred, and whether those changes have not been appropriately disclosed in MD&A when they occurred, on a timely basis.

Now I would like to discuss our to do list for the upcoming year. We have many things we plan to focus on during 2001-I will highlight just a few items.

On August 31, 2000, the Panel on Audit Effectiveness issued its final report and recommendations. The Panel's examination was a comprehensive, independent, in-depth analysis into the way audits are performed. It was a study of not only the effectiveness of audits, but also the environment in which audit firms operate, the factors that drive their business, their operational management, the types of services they perform as well as the system of self regulation and governance that exists today. The staff believes that the recommendations included in the final report, if appropriately implemented, will go a long way toward improving audits. The staff believes that it is important that the Public Oversight Board ensure, on behalf of the public, that the recommendations included in the final report are successfully implemented in full, on a timely basis.

One area the Panel addressed was the topics resulting in SEC Accounting and Auditing Enforcement Releases (AAERs). The Panel reviewed the AAERs to obtain additional insights regarding the characteristics that frequently were present in actual or alleged instances of fraudulent financial reporting and audit failures, as well as insights regarding the auditors' work that either resulted in detecting or not detecting material misstatements.

The Panel's analysis provided the following observations about techniques used to facilitate frauds:

- Entities used information technology, such as making inappropriate modifications to computer programs;

- Inappropriate non-standard journal entries were made; and
- Management, including the Chief Executive Officer and Chief Financial Officer, had often overridden internal accounting controls.

The SEC's enforcement cases also highlight that auditors often identify improper financial reporting and confront the client with the issue. However, management then provides an explanation that the auditor accepts without obtaining appropriate verifiable evidence.

Given the Panel's observations, auditors should be aware of these and other techniques to materially misstate financial statements. For example, the staff expects that in performing appropriate audit procedures, the auditor will gain an understanding of the nature and volume of non-standard journal entries, how non-standard journal entries are processed, what controls exist that are effective in ensuring that non-standard journal entries are properly recorded, and to what extent there is adequate segregation of duties and supervision. The auditor should ensure that sufficient, competent, verifiable evidential matter is obtained to support the auditor's conclusion that the non-standard journal entries selected for testing are properly recorded.

Again, expect the staff to closely monitor the profession as it begins to consider and implement the Panel's recommendations.

Now, allow me to touch on some of the possible rule making activities that are in the works. The SEC staff is currently working on a rule proposal to clarify and expand certain supplementary disclosure requirements concerning activity in valuation and loss accrual accounts. The proposed revisions are intended to provide investors with more transparent, better-detailed disclosures concerning changes in these accounts.

The staff has received comment letters on the proposed rule. One concern expressed by commentators from the preparer community was that the proposed detailed disclosures concerning litigation and income tax loss accruals would be punitive since compliance with the proposal would require companies to disclose information of a confidential nature. We appreciate that concern and the staff is considering alternatives to address it.

The staff is developing a rule proposal to amend FRR 48 that, if adopted, would revise the definition of a derivative to be consistent with Statement 133. Further, under the proposal the accounting policy disclosures under 408(n) would be eliminated because Statement 133 establishes the basis for the accounting for derivatives.

Allow me now to comment on some AICPA activities. Recently, the SEC staff asked that the AICPA undertake a project, under the oversight of the FASB, to provide common definitions to a core set of non-GAAP performance measures including critical success factors and key performance indicators. These are often contained in analysts' reports and the FASB Steering Committee has identified some. In the meantime, because non-GAAP performance measures such as EBITDA are calculated on different bases by different registrants, companies that voluntarily present this measure in a filing document have been requested by the staff to show the composition of the measure.

The SEC staff noted that part of this project, as noted in speeches by

Chairman Levitt and Chief Accountant Turner, would need to address the classification of items in the financial statements. For example, if a key performance indicator for a company is the percentage of revenues spent on marketing, then the consistent classification of what constitutes marketing expenses is necessary to achieve comparability from company to company.

In another recent request, the SEC staff asked that the AICPA continue and expand its leadership in addressing an important issue - providing guidance on valuation models and methodologies used to measure fair value and the auditing of those measurements. In today's dynamic economy, financial statement users have become increasingly interested in the fair values of a company's assets and liabilities, in addition to the historical cost information that also is provided in the financial statements. Further, many existing and proposed accounting standards require companies to measure more assets and liabilities at fair value. As a result, there is increasing need to improve the quality and comparability of fair value measurements and the auditing of those measurements. Therefore, the staff has encouraged the AICPA to take a larger leadership role, by developing detailed, broad-based guidance on valuation models and methodologies used (a) to measure fair value, under the oversight of the FASB, and (b) in auditing fair value estimates.

Efforts to educate are important too. Preparers, auditors, and even some users need to become more educated on fair value estimates - how they are calculated and what they mean. In addition, educational curricula need to be modified to more effectively teach valuation techniques, the meaning of fair value, and how financial instruments work. The staff believes that the AICPA, as a leader in the accounting profession, is in a unique position to promote the changes necessary to better educate those concerned.

Let's shift gears one more time and talk about international activities. The SEC, as you may know, is a member of IOSCO, the International Organization of Securities Commissions. Earlier this year, IOSCO completed a comprehensive assessment of 30 core IASC standards, and recommended that IOSCO members accept cross-border filings in IAS, subject to three supplemental treatments: reconciliation, interpretation, and disclosure, where needed to meet national requirements. The SEC already accepts IAS with reconciliation to U.S. GAAP, which is consistent with IOSCO's recommendation.

There is a strong interest in recognizing and supporting the work of the IASC, while maintaining the high level of investor protection that has made our U.S. markets so strong. And, the staff also will continue to recognize and support the work of the FASB, AcSEC, and the EITF, who have done so much to provide the transparency in financial reporting that is an essential underpinning of investor confidence.

As the staff evaluates the best course of action, the key elements the Commission originally established for further acceptance of IAS will guide us:

1. The standards must constitute a comprehensive, generally accepted basis of accounting
2. The standards must be of high quality - they must result in comparability and transparency, and they must provide for full disclosure; and

3. The standards must be rigorously interpreted and applied.

Convergence on the highest quality standards - a "best of breed" approach to accounting - is a goal that the staff believes should be achieved. The staff will be looking for the world's private standards setters to provide leadership in making this happen.

The staff believes that the one way to deal with the reconciling items we commonly see today is for the recently enhanced IASC to set an initial agenda in cooperation with the national standards setting bodies, which would result in the identification of the reconciling items which are most common and for which the greatest diversity exists, and then the IASC and national standard setters converge on the highest possible standard. That would in and of itself eliminate some of the items requiring reconciliation today. In the meantime, the staff will continue to take a keen interest in monitoring and supporting this work.

In a related matter, let me observe that numerous efforts are underway to improve auditing standards throughout the world and the staff strongly supports those initiatives.

Finally, let me touch on independence. The staff has received some calls on how to interpret certain aspects of the new auditor independence rules. In response, the staff is considering whether to publish answers to a list of questions that it has developed from those calls.

That concludes my prepared remarks that will be made available on our website shortly. Thank you again for this opportunity to speak with you.

Footnotes

¹ Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements*.

² Staff Accounting Bulletin No. 74, *Disclosure of Impact of Recent Accounting Standards Issued But Not Yet Adopted*.

³ FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

⁴ FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities - a Replacement of FASB Statement No. 125*.

⁵ FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

⁶ Staff Accounting Bulletin No. 59, *Noncurrent Marketable Equity Securities*.

⁷ Financial Reporting Release No. 36, *Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures*.

⁸ FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*.

⁹ Staff Accounting Bulletin No. 100, *Restructuring and Impairment Charges* .

¹⁰ APB No. 20, *Change in Accounting Estimate*.

¹¹ FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* .

<http://www.sec.gov/news/speech/spch454j.htm>

[Home](#) | [Previous Page](#)

Modified: 01/09/2001