

# Accounting Roundup

February 18, 2002

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### >> FASB Considers Approaches to Identifying and Accounting for SPEs

At its February 13, 2002 meeting, the Financial Accounting Standards Board (FASB or "the Board") considered proposed approaches related to identifying and accounting for special-purpose entities (SPEs). The Board agreed to base the project on a recent draft of a possible interpretation of Statement of Financial Accounting Standards (SFAS) No. 94, *Consolidation of All Majority-Owned Subsidiaries*, prepared by the FASB staff. The final interpretation is expected to focus on the qualitative characteristics of an SPE's third-party owners. Consideration will be given to whether third-party owners have real equity and real ownership at risk in the SPE or whether they are protected by a guarantee from the primary beneficiary. The Board admitted that, to make this guidance operational, a qualitative assessment would be needed. The Board is likely to require that the equity investment held by third-party owners be no less than 10 percent.

The Board acknowledged that this is a high-visibility project and that there is an expectation that the issues will be resolved quickly. The Board expects to discuss the interpretation at its February 27, 2002 meeting.

The FASB staff requested, and the Board agreed, to expand the scope of this project to include the accounting and disclosure by issuers of guarantees, because guarantees are commonly found in SPE structures, although they can also be found in non-SPE structures. These issues will be addressed in an interpretation separate from the SPE interpretation. The FASB staff will present the proposed scope of the entire project to the Board at its February 20, 2002 meeting for the Board's approval.

### >> FASB Discusses Comment Letters on Rescission Exposure Draft

At its February 7, 2002 meeting, the FASB redeliberated the provisions of the Exposure Draft, *Rescission of FASB Statements No. 4, 44, and 64 and Technical Corrections* ("the Exposure Draft"), that was issued on November 15, 2001. The Board's discussion focused on the 30 comment letters received during the comment period, which ended January 14, 2002. At this meeting, the Board agreed to rescind SFAS No. 4, *Reporting Gains and Losses from Extinguishment of Debt*, and SFAS No. 64, *Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements*. The Board noted that there was strong support in the comment letters for these rescissions. The Board said that it had received no comment letters indicating that there were any transactions or issues related to the transition to the provisions of the Motor Carrier Act of 1980 that would require retention of SFAS No. 44, *Accounting for Intangible Assets of Motor Carriers*. Therefore, the Board also agreed to rescind SFAS 44.

### Proposed Amendments to the Exposure Draft

The comment letters resulted in one proposed amendment to the Exposure Draft. That amendment relates to the distinction between capital leases of property other than real estate, including integral equipment, and capital leases of real estate, including integral equipment, which is reflected in the Exposure Draft's proposed amendment to paragraph 38 of SFAS No. 13, *Accounting for Leases*. Respondents commented that the same distinction should also be applied to paragraph 14(a) of SFAS 13 with respect to modifications of leases involving real estate,

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including integral equipment, whose classification changes from capital to operating. Further, many respondents commented that to be consistent with SFAS No. 98, *Accounting for Leases*, not only should the gain or loss recognized on such transactions be subject to SFAS No. 66, *Accounting for Sales of Real Estate*, if the leased asset is real estate, including integral equipment, but the resulting operating lease should be subject to the sale-lease-back rules of SFAS 98 as well. The Board generally agreed with this view but noted that this recommended amendment would be subject to due process. The Board agreed to issue an Exposure Draft of the proposed amendment by posting it to the FASB's website, with a 30-day comment period. There were no other proposed amendments.

The Board changed two of the transition provisions in the Exposure Draft, as follows:

- The rescission of SFAS 4 will still be effective as of the beginning of the fiscal year in which a final Statement is issued, with early adoption encouraged, but, once applied, enterprises must reclassify prior-period items that do not meet the extraordinary-item classification criteria in APB Opinion No. 30, *Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*.
- The proposed amendments to SFAS 13 will apply only to new transactions that occur after the Statement is issued.

The Board directed the FASB staff to prepare a ballot draft that includes the proposed amendment to SFAS 13, for vote by the Board at a future meeting.

## >> **SFAS 133 and Accounting for Beneficial Interests Arising From a Securitization**

At its January 30, 2002 meeting, the Board discussed comments received from constituents in connection with certain Implementation Issues relating to SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The Implementation Issues discussed, which are listed below, were originally posted to the FASB's website on October 12, 2001.

- Issue No. A20, "Application of Paragraph 6(b) regarding Initial Net Investment"
- Issue No. B12, "Embedded Derivatives in Beneficial Interests Issued by Qualifying Special-Purpose Entities"

- Issue No. C17, "Application of the Exception in Paragraph 14 to Beneficial Interests that Arise in a Securitization"
- Issue No. D2, "Applying Statement 133 to Beneficial Interests in Securitized Financial Assets (a Resolution of the Issues Raised in Implementation Issue D1)"
- Issue No. E21, "Continuing the Shortcut Method after a Purchase Business Combination."

The Issues identified address questions surrounding the application of SFAS 133 to beneficial interests issued in securitization transactions subject to SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, which were originally addressed in the FASB staff's interim guidance in SFAS 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets." Several topics within these Issues were discussed, including (1) bifurcation of beneficial interests, (2) bifurcation of embedded credit-linked beneficial interests that are linked to a security outside the special-purpose entity, and (3) consideration of all beneficial interests issued by qualifying special-purpose entities (QSPE) to be debt hosts even if they are equity in form.

The Board also considered whether to amend SFAS 140 to address the interaction of SFAS 133 and SFAS 140, but decided not to amend the Statement. Instead, Board members agreed on transition provisions that grandfather existing QSPE structures that have a derivative that, based on the revised guidance in these Implementation Issues, does not meet the requirements in paragraphs 35(c)(2) and 40 of SFAS 140. These grandfathered QSPEs would therefore retain their qualifying status under SFAS 140, despite the requirements of paragraphs 35(c)(2) and 40. However, the Board said that there would be no grandfathering of the SFAS 133 implications of these Issues.

The Board's decisions with respect to the Issues discussed will be incorporated into revised drafts of the tentative Implementation Issues, which are expected to be released in mid February. They will also eventually be incorporated into an Exposure Draft of an amendment to SFAS 133.

Guidance on SFAS 133 Implementation Issues is available on the FASB's website, <http://www.fasb.org> (select Technical Projects in the left menu frame, then click on Derivatives Implementation Group and then Guidance on Statement 133 Issues).

## >> FASB Requests Comments on Proposed Major Project

On January 28, 2002, the FASB posted on its website a proposal to add a major project to its agenda related to the recognition of revenues and liabilities. The Board is requesting comments from constituents on the proposed scope and potential importance of the project. The proposal is available on the FASB's website, <http://www.fasb.org>. The comment period ends on March 29, 2002.

## >> SEC Announces Proposed New Disclosure Rules

On February 13, 2002, the U.S. Securities and Exchange Commission (SEC) announced that it intends to propose changes to its corporate disclosure rules. In the press release, SEC Chairman Harvey Pitt said, "The steps we announce today represent only a beginning in the realization of an important regulatory agenda. These steps will provide significant improvements quickly while other proposals are considered. We anticipate further reform proposals covering financial reporting and disclosure requirements, accounting standard setting, regulation of the auditing process and profession and corporate governance." The press release is summarized below, and the full text is available on the SEC's website at <http://www.sec.gov/news/headlines/corpdiscrules.htm>.

The SEC intends to propose the following rules.

- Companies would disclose on a current basis significant transactions in the company's stock by their executive officers and directors, including transactions involving the company itself. The SEC is looking for ways to enable companies to file this information electronically.
- Companies would be required to file their Form 10-Ks within 60 days after the fiscal year-end and to file their Form 10-Qs within 30 days after the end of the respective quarter. This would accelerate the filing deadlines by 30 days and 15 days, respectively, from current requirements.
- The list of significant events that require disclosure on a Form 8-K would be expanded. The SEC is evaluating several items for inclusion in this list. Some examples are (1) changes in rating agency decisions; (2) defaults and other events that could trigger the acceleration of the company's obligations; (3) the departure of the company's CEO, CFO, COO, or president; (4)

notice that reliance on a prior audit is no longer permissible or that the auditor will not consent to use of its report in a filing; (5) definitive agreements that are material to the company; (6) any loss or gain of a material customer or contract; (7) any material write-offs, restructurings, impairments, or changes in accounting policies; and (8) any material events, such as beginning or end of a lock-out period or material events involving the employee's benefit or retirement plans. [Note: The entire list of items that the SEC is evaluating is available in the full text of the press release.]

- Companies would be required to post their Exchange Act reports on their websites, if applicable, at the same time they are filed with the SEC. This requirement would not replace the company's obligation to file with the SEC.
- Companies would be required to include in Management's Discussion and Analysis (MD&A) full explanations "in clear and understandable format and language" of their critical accounting policies, judgments, and uncertainties affecting the application of these policies and the likelihood that materially different amounts would be reported under different conditions or using different assumptions.

The SEC said in its press release that it will issue proposing releases on these matters for public comment, "with the intent to adopt new rules as quickly as possible."

## >> SEC Chief Accountant Addresses Senior Financial Executives Conference

On January 24, 2002, the Chief Accountant of the SEC, Robert K. Herdman, addressed the Financial Executives International's (FEI) San Diego chapter's Annual SEC Update. Portions of the Chief Accountant's speech are excerpted below. The full text of the speech is available on the SEC's website at <http://www.sec.gov/news/speech/spch537.htm>.

Mr. Herdman seemed to be focusing primarily on recent actions taken by the SEC with an emphasis on the roles of senior financial executives. He said that the SEC has taken three "immediate" steps towards improving the upcoming 2001 financial reporting requirements by issuing the three Financial Reporting Releases (FRR or "Release") discussed as follows.



## Critical Accounting Policies

On December 12, 2001, the SEC issued FRR No. 60, *Cautionary Advice Regarding Disclosure About Critical Accounting Policies* (available on the SEC's website at <http://www.sec.gov/pdf/33-8040.pdf>). FRR 60 encourages registrants and their auditors to "pay special attention" to a registrant's "three to five most critical accounting policies." Mr. Herdman said that a critical accounting policy is one that is "both very important to the portrayal of the company's financial condition and results and requires management's most difficult, subjective or complex judgments." He said that at the heart of the Release is the importance of an investor's understanding how management forms its judgments about future events, including the variables and assumptions underlying estimates and the sensitivity of those judgments in different circumstances. The Chief Accountant commented that MD&A is the "ideal location for providing disclosures regarding these critical accounting policies." He said that senior financial executives should "take a fresh look" at whether their companies' MD&A clearly portrays the significance of management's assumptions about future events to the current accounting results.

Mr. Herdman provided three examples to illustrate his point that the types of disclosures required by FRR 60 are "dynamic." The examples included an energy trading example, a loan loss allowance example, and a product warranty example (see the full text of Mr. Herdman's speech at <http://www.sec.gov/pdf/33-8040.pdf>). Mr. Herdman concluded his comments on critical accounting policies by stating that the SEC intends to initiate rule making this year to formalize the requirements for these disclosures.

## Statement On MD&A Disclosures

On January 22, 2002, the SEC issued FRR No. 61, *Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations*, after being petitioned to do so by the "Big Five" accounting firms, as endorsed by the American Institute of Certified Public Accountants (AICPA). FRR 61 is available on the SEC website at <http://www.sec.gov/rules/other/33-8056.htm>.

FRR 61 provides guidance on three areas in MD&A:

- Liquidity and capital resources, including off-balance-sheet arrangements

- Certain trading activities involving nonexchange-traded contracts accounted for at fair value
- Relationships and transactions on terms that would not be available from clearly independent third parties.

Mr. Herdman said that this Release is only a first step towards "improving financial reporting" and is meant to suggest steps that should be considered in meeting the current MD&A disclosure requirements. The Chief Accountant said that senior financial executives should "capitalize on the flexibility" of the current MD&A rules and "avoid discussions that are boilerplate and simply translate the financial statements from numbers into words." He pointed out that the SEC staff can be expected to challenge MD&A discussions that are "unclear, boilerplate and missing or misleading." He also stated that he believes that FRR 61 can provide good insights about improving a registrant's MD&A disclosures.

## Pro Forma Earnings Release

On December 4, 2001, the SEC issued FRR No. 59, *Cautionary Advice Regarding the Use of "Pro Forma" Financial Information in Earnings Releases* (available on the SEC website at <http://www.sec.gov/rules/other/33-8039.htm>). Mr. Herdman said that one of the key points of this Release is that the antifraud provisions of the federal securities laws apply to a company issuing pro forma financial information. The SEC has recently concluded its first pro forma financial reporting case relating to the issuance of a misleading earnings release.

Mr. Herdman said that registrants should strive to "not deviate" from the guidelines jointly developed by FEI and the National Investors Relations Institute, in addition to FRR 59, in developing or reviewing pro forma financial information in earnings releases. Mr. Herdman said that registrants should include, in particular, a reconciliation of the pro forma results to or from the GAAP results and should disclose the amount of each item.

The Chief Accountant closed his remarks stating that "this year's MD&A ought not just be a markup of last year's."

## >> January 29, 2002 AcSEC Meeting

At its January 29, 2002 meeting in New York, the AICPA's Accounting Standards Executive Committee (AcSEC) discussed the following topics and took the indicated actions:

### **Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations**

AcSEC agreed with the tentative conclusion in this proposed Statement of Position (SOP) that not-for-profit health care organizations should apply the provisions of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* (including the provisions pertaining to cash flow hedge accounting), in the same manner as for-profit entities. The task force developing the proposed SOP was asked to revise the document to include additional guidance and examples and to address certain questions and concerns related to transition issues.

### **Accounting by Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements**

AcSEC agreed with the preliminary recommendation of this proposed SOP that would specify how insurance enterprises should account for unamortized deferred acquisition costs (DAC) existing at the time of internal replacements, other than in those situations covered by FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*. Under the proposed SOP, the accounting depends on whether the replacement is considered to be an extinguishment or a continuation of the original contract.

- If considered an extinguishment (i.e., if the replacement contract has terms that differ substantially from the original contract), then the DAC would not be deferred in connection with the replacement.
- If considered a continuation (i.e., if the replacement contract does not have terms that differ substantially from the original contract), then the DAC would continue to be deferred.

The task force developing the proposed SOP was asked to revise the document to include additional guidance and examples.

## **Liaison Meeting With the AICPA'S Technical Issues Committee**

AcSEC also met with the AICPA's Technical Issues Committee to discuss various AcSEC projects and other matters of mutual interest.

## >> Next AcSEC Meeting

At its next meeting, scheduled for March 5-6, 2002, in New York, AcSEC plans to discuss:

- Allowance for Credit Losses
- Accounting by Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements
- Accounting for Risk Transfer in Mortgage Reinsurance Arrangements That Involve Participation of Mortgage Lenders
- Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations.

Further information about AcSEC can be obtained at the AICPA website at

<http://www.aicpa.org/members/div/acctstd/index.htm>.

## >> Next IASB Meeting

The next meeting of the International Accounting Standards Board (IASB or "the Board"), including sessions with its Standards Advisory Council, is scheduled for February 18-22, 2002, in London. The Board expects to discuss the following topics:

- Business Combinations
- First-Time Application of International Financial Reporting Standards
- Improvements to IAS No. 27, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries*, and IAS No. 28, *Accounting for Investments in Associates*
- Amendments to IAS No. 32, *Financial Instruments: Disclosure and Presentation*, and IAS No. 39, *Financial Instruments: Recognition and Measurement*
- Insurance Contracts
- Reporting Performance
- Share-based Payment.

Further information about the IASB can be obtained at the IASB's website, <http://www.iasc.org.uk>.

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