

SEC REGULATIONS COMMITTEE
Joint Meeting with SEC Staff
July 31, 1996
SEC Headquarters—Washington, D.C.

HIGHLIGHTS

I. ATTENDANCE

A. SEC Regulations Committee

Thomas L. Milan, Chairman
John L. Archambault
Val Bitton
Rusty Brinkman
Michael D. Foley
Jay P. Hartig
Eric Press
Lucien K. Sandefur
Stewart Sandman

B. Securities and Exchange Commission

Office of the Chief Accountant

Michael H. Sutton, Chief Accountant
Steve Swad, Deputy Chief Accountant
Robert Bums, Chief Counsel
Donna Collier, Professional Accounting Fellow
Brian Heckler, Professional Accounting Fellow
Mike Kigin, Associate Chief Accountant
Robert F. Lavery, Assistant Chief Accountant
Timothy McKay, Assistant Chief Accountant
Russell Mallett III, Professional Accounting Fellow
Armando Pimentel, Professional Accounting Fellow
Cody Smith, Professional Accounting Fellow
Roy Van Brunt, Assistant Chief Accountant

Division of Corporation Finance

Robert Bayless, Chief Accountant
Wayne Carnall, Associate Director -- Accounting Operations
Melanie Fowler, Assistant Chief Accountant

Douglas Tanner, Associate Chief Accountant

C . AICPA Staff

Annette Schumacher Barr, Technical Manager

D . Guests

Wendy Hambleton, BDO Seidman
Chris Holmes, Ernst & Young
Steven Sherb, Feldman, Radin & Co.

II. STAFF UPDATE

Mike Sutton introduced the new Professional Accounting Fellows (PAFs) who joined the Office of the Chief Accountant in June: Donna Collier, Armando Pimentel and Cody Smith. Mr. Sutton also announced that Roy Van Brunt, Assistant Chief Accountant, will leave the SEC in August to take a position with Ten Eyck & Associates. He thanked Mr. Van Brunt for his 20 years of dedicated service to the Commission.

Wayne Carnall announced the formation of a Professional Accounting Program in the Division of Corporation Finance. He stated that the Commission will accept applications for 6 to 8 accounting positions with a nonrenewable term of twelve to twenty-four months. The deadline for application is August 26, 1996.

Robert Bayless added that the Division of Corporation Finance is also seeking an independent contractor to work as a staff trainer for one year. Anyone interested in this position should contact the Division for more information.

III. SAB 97 OVERVIEW

Brian Heckler provided an overview of Staff Accounting Bulletin (SAB) No. 97, issued July 31, 1996. The first section of the SAB provides the staff's views regarding the inappropriate application of SAB No. 48, Transfers of Nonmonetary Assets by Promoters or Shareholders, to purchase business combinations consummated just prior to or concurrent with an initial public offering (IPO). In discussing this section, Mr. Heckler

highlighted the transitional guidance contained in Footnote 2 to the Interpretive Response for Question 1 of Topic 2:A (8). Footnote 2 states that "the staff generally will not object to the application of SAB Topic 5:G (SAB 48) to business combinations entered into just prior to or contemporaneously with, an IPO for which merger agreements were executed by all of the combining companies prior to the publication of this guidance and the initial public offering is filed with the Commission by September 30, 1996."

The second section of SAB No. 97 expresses the staff's views regarding the identification of an accounting acquirer in accordance with APB Opinion No. 16, *Business Combinations*, for purchase business combinations involving more than two entities. Specifically, the SAB states that the company whose shareholders receive the largest ownership interest in the combined entity should be presumed to be the accounting acquirer unless "objective and verifiable evidence rebuts that presumption."

Mr. Heckler added that the guidance in the SAB does not address the accounting for joint ventures or leveraged buy-out transactions as discussed in EITF Issue No. 88-16.

IV. PROPOSED DERIVATIVE DISCLOSURES

Russ Mallett noted that the Commission received over 100 comment letters on the recent rules proposal on derivative and market risk disclosures. He provided the following summary of the comment letters that the staff has reviewed thus far:

- The SEC should defer any action until the FASB completes its derivatives accounting project.
- Financial instrument market risk does not necessarily represent a registrant's primary market risk exposure. For example, risks relating to changes in technology or foreign operations may represent a more dominant risk. In these cases, the proposed market risk disclosures would not provide for a balanced discussion of a company's business and economic risks.
- The proposal's requirement to disclose certain quantitative information (such as commodity positions) may result in competitive harm to registrants.
- The proposed qualitative disclosures are more useful/meaningful than the proposed quantitative disclosures.
- Registrants should be afforded more flexibility in determining which quantitative disclosures should be provided. Registrants should be allowed to disclose internal quantitative measures of market risk exposure.

- In order to ensure comparability, *less* flexibility should be provided registrants in determining which quantitative disclosures should be provided. Issuer discretion whether to include the encouraged quantitative market risk exposures could also lead to possible manipulation of the disclosures provided.
- The final rule should either provide more explicit materiality guidelines or adopt the existing materiality standards applicable to MD&A disclosures.
- Various technical and editorial corrections are needed.

Mr. Mallett stated that the staff is in the process of considering and analyzing each of the comment letters received. The goal of the staff is to provide timely guidance for calendar year 1996 reporting. He added that the staff considers the SEC's derivatives and market risk proposal as a stand-alone disclosure standard that is independent of the FASB's derivative accounting project (i.e., the issuance of the FASB's standard generally will not eliminate the need for the SEC's final disclosure rule).

V. REVENUE RECOGNITION AND DEFERRED COSTS

Brian Heckler noted that the staff has recently addressed several revenue recognition issues. The staff consistently questions transactions where revenue appears to be recognized prior to the registrant's completion of significant legal and contractual activities.

The staff is skeptical about the assertion that revenue has been earned if a customer has a legal and enforceable right to a refund or demand performance. Registrants have asserted that revenue has been earned even though clearly articulated language in legal contracts and other documents stipulate that additional performance obligations or conditions to customer acceptance exist. For example, a registrant delivered a product subject to a right of return after a 30 day acceptance period. Title to the property did not pass until acceptance. The registrant asserted that customer acceptance was not an important milestone and that revenue should be recognized upon delivery. The staff objected to the recognition of revenue prior to customer acceptance.

In another example, a registrant had a business where memberships were sold for an initial fee. The customer subsequently paid a monthly service fee over a period of use. The registrant allocated certain marketing costs to the initial nonrefundable fee and, if marketing costs exceeded the fee plus an expected gross profit margin, accrued some of the future expected revenues to offset the initial marketing costs. The registrant and its

auditors cited industry practice as the principal support for the recognition of revenue in this manner. The staff objected to the registrant's revenue recognition policy. Instead, the staff believed it was appropriate to defer and amortize the initial fee over the contract period and to recognize costs when incurred unless those costs were customer acquisition costs.

The staff has not objected, in certain circumstances, to a registrant's assertion that certain "customer acquisition costs" could be deferred and amortized over an appropriate period. The customer acquisition costs subject to deferral were direct and incremental costs related to obtaining the customer and included only those costs related to successful efforts. The staff reaffirmed that advertising costs are subject to the provisions of SOP 93-7, *Reporting on Advertising Costs*. The staff objected to a registrant's assertion that certain general and administrative expenses, including occupancy costs, related to and could be deferred as customer acquisition costs.

Steve Swad added that registrants with revenue recognition issues should write the staff on a pre-filing basis to discuss the issues and get the staff's position on the proposed revenue recognition approach.

VI. REORGANIZATION IN THE DIVISION OF CORPORATION FINANCE

Robert Bayless provided an overview of the recent reorganization of the Division of Corporation Finance. The purpose of the reorganization, designed by the new Division Director Brian Lane, is to improve the management and integration of the both legal and accounting review processes. The reorganization is primarily internal and will have little visible impact on registrants and their auditors. Generally speaking, the reorganization will not result in the reassignment of a transitional filing that was assigned to a specific staff member prior to July 15, 1996, the date of reorganization. As a result of the reorganization, the Division replaced its existing 12 disclosure branches with eight Assistant Director Offices and an Office of Small Business Review. Additional information, including a list of primary SIC codes assigned to the eight Assistant Director Offices, is available on the Commission's web site (<http://www.sec.gov>).

Mr. Bayless added that although the reorganization occurred during a peak period for IPO filings (over the last eight weeks, the number of IPOs filed each week dropped from a peak of nearly 200 to about 100) the protocol for processing filings has not changed. Comment letters will identify the accounting and legal reviewers and their respective supervisory reviewers. Registrants are still encouraged to call the staff with any questions or concerns related to their filings.

With respect to current filings, Robert Bayless noted that the staff is working hard to keep up with the increased level of IPO filings referred to above. Registrants may call the Division with questions about the status of their filings. He added that incomplete filings containing significant deficiencies will be returned to registrants.

VII. RULE 3-05 STREAMLINING

Robert Bayless provided a status update on the Rule 3-05 streamlining proposals announced last year by the Commission. He noted that the staff's goal is to present an adopting release to the Commission by the end of August. In addition, the staff may need to re-propose certain revised rules. With respect to the public comments that were received on the proposal, Mr. Bayless said that while most of the comments were supportive of the proposed relief, some contained recommendations for lower limits. For example, some commenters stated that the proposed relief should not extend to acquisitions above a specified level while others suggested that the proposed relief should extend only to "seasoned" issuers.

VIII. BEST PRACTICES

Tom Milan discussed the Committee's project to develop a compendium of best practices for consultation between independent auditors and the SEC staff. The goal of the project is to improve communications between independent auditors and the SEC staff and would not result in authoritative requirements for SEC Practice Section (SECPS) members. Mr. Milan added that, because communication is a two-sided issue, the project could not proceed without a similar project by the SEC staff to determine and document their best practices for communications with independent auditors.

Mike Sutton noted that the staff would be open to discuss practices that would improve communications between the staff and the profession.

IX. STOCK SPLITS

The Committee requested clarification of the staff's expectations for the reporting of a stock split that must be given retroactive effect subsequent to the filing of Form 10-K. The Committee inquired whether the staff would require amended financial statements with revised per share amounts in a subsequent registration statement or in a Form 8-K incorporated by reference. Robert Bayless responded

that although stock splits require retroactive presentation, the staff would not ordinarily require the restatement of previously filed financial statements that are incorporated by reference into a registration statement or proxy for reasons solely attributable to a stock split. In lieu thereof, the staff will accept inclusion of selected financial data which includes per share information, as restated, for all periods, with prominent disclosure of the stock split.

X. IMPAIRMENT UNDER THE FULL COST METHOD

Robert Bayless stated that the staff has performed an electronic search of its EDGAR filings and has identified 48 registrants that follow the full cost method of accounting for oil and gas producing activities. The staff has sent letters to each of these registrants advising them of the staff's position that, although FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* applies to all entities, it does not apply to costs capitalized pursuant to the full cost method pursuant to Rule 4-10(i) of Regulation S-X. Costs capitalized pursuant to the full cost rules should continue to be evaluated for impairment as specified by Rule 4-10(i) of Regulation S-X.

XI. CHANGES IN AUDITORS

The Committee asked the staff to clarify its position regarding the reporting requirements when a change in auditors will occur upon completion of the current year's audit. Robert Bayless responded that a registrant may engage a new auditor prior to the termination of the predecessor accountant who is completing the audit of the current fiscal year. A termination occurs when a new accountant is hired. The registrant should file an Item 4, Form 8-K, when the new auditor is formally engaged, which should report the change, identify disagreements or reportable events, and include the predecessor auditor's letter.

Mr. Bayless added that an amendment under cover of Form 8-K should be filed within five days after the predecessor auditor's final audit report on the registrant's financial statements is filed with the Commission. The amendment should include whether there are any disagreements through that date and include a confirming auditor's letter.