

**AICPA SEC Regulations Committee
September 26, 2006 - Joint Meeting with SEC Staff
SEC Offices – Washington DC**

HIGHLIGHTS

NOTICE: The AICPA SEC Regulations Committee meets periodically with the staff of the SEC to discuss emerging technical accounting and reporting issues relating to SEC rules and regulations. The purpose of the following highlights is to summarize the issues discussed at the meetings. These highlights have not been considered and acted on by senior technical committees of the AICPA, or by the Financial Accounting Standards Board, and do not represent an official position of either organization.

In addition, these highlights are not authoritative positions or interpretations issued by the SEC or its Staff. The highlights were not transcribed by the SEC and have not been considered or acted upon by the SEC or its Staff. Accordingly, these highlights do not constitute an official statement of the views of the Commission or of the Staff of the Commission.

I. ATTENDANCE

A. SEC Regulations Committee

John Wolfson, Chair
Jack Ciesielski
Melanie Dolan
David Follett
Karin French
Jay Hartig
Steve Henning
David Hinshaw
Chris Holmes
Bob Laux
Jeff Lenz
Scott Pohlman
Amy Ripepi

B. Securities and Exchange Commission

Office of the Chief Accountant

Scott Taub, Deputy Chief Accountant
Tammy Bieber, Senior Advisor to the Chief Accountant
Mark Barrysmith, Professional Accounting Fellow

Robert Burns, Chief Counsel
Cathy Cole, Associate Chief Accountant
Brian Croteau, Associate Chief Accountant
Mike Gaynor, Professional Accounting Fellow
Amy Hargrett, Assistant Chief Accountant
Melanie Jacobsen, Special Counsel
Josh Jones, Professional Accounting Fellow
Jeff Kessman, Assistant Chief Accountant
Sandie Kim, Professional Accounting Fellow
Mark Mahar, Associate Chief Accountant
Joseph McGrath, Professional Accounting Fellow
Jennifer Minke-Girard, Senior Associate Chief Accountant
Thomas Noland, Academic Fellow
Zoe-Vonna Palmrose, Deputy Chief Accountant for Professional Practice
Marlene Plumlee, Academic Fellow
Nancy Salisbury, Senior Associate Chief Accountant
Alison Spivey, Associate Chief Accountant
Charlotte Thomas, Research Specialist
Cheryl Tjon-Hing, Valuation Specialist
Joseph Ucuzoglu, Professional Accounting Fellow

Division of Corporation Finance

Carol Stacey, Chief Accountant
Craig Olinger, Deputy Chief Accountant
Parveen P. Gupta, Academic Fellow
Stephanie Hunsaker, Associate Chief Accountant
Todd Hardiman, Associate Chief Accountant
Joel Levine, Associate Chief Accountant
Rachel Mincin, Associate Chief Accountant
Leslie Overton, Associate Chief Accountant
Michael Stehlik, Business Associate
Sondra Stokes, Associate Chief Accountant

Division of Enforcement

Susan Markel, Chief Accountant

C. AICPA Center for Public Company Audit Firms

Annette Schumacher Barr

D. Guests

Karen Van Compernelle, D&T
Wes Williams, Crowe Chizek

II. DIVISION UPDATES

A. Office of the Chief Accountant (OCA) Update

Scott Taub provided the following update of the activities in the Office of the Chief Accountant:

- Staffing Update
 - Conrad Hewitt joined the SEC on August 18, 2006 as the new Chief Accountant.
 - Zoe-Vonna Palmrose joined the SEC on August 2, 2006 as the new Deputy Chief Accountant for Professional Practice. Ms. Palmrose will oversee the Commission's work on audit standards and independence and serve as the PCAOB liaison.
 - OCA has been given the authority to hire three additional staff for which the postings have recently closed. OCA anticipates additional position postings soon.
 - Ashley Carpenter and Katrina Kimpel will soon join OCA as Professional Accounting Fellows and will serve two-year terms.
- Other OCA Developments

SAB No. 108. The SEC staff recently issued Staff Accounting Bulletin No. 108 regarding the process of quantifying financial statement misstatements. The SEC staff indicated that specific questions have been raised regarding the application of SAB 108 and that they are working on developing answers to these questions. The SAB can be obtained from the SEC website at:

<http://www.sec.gov/interps/account/sab108.pdf>

OCA Letter on Stock Options. Chief Accountant Conrad Hewitt recently issued a letter expressing the SEC staff's views on the appropriate application of existing accounting guidance related to grants of stock options. The SEC staff emphasized that the letter does not address manipulative backdating of stock options, nor does it suggest that any registrant involved in manipulative backdating does not have significant problems. The SEC staff also indicated that the letter had been drafted carefully and speaks for itself. Therefore, the SEC staff has declined requests to provide further guidance or information on the issues discussed in the letter. The SEC staff is not aware of any additional information that should have been included in the letter.

The Committee asked about a statement in the letter indicating, "Companies that propose to correct material errors without amending all previously filed reports should contact the staff of the Division of Corporation Finance." The Division of Corporation Finance noted that it might issue general guidance and identify additional factors registrants

should consider in evaluating filings that require amendment. The guidance may be in the form of an alert or letter. The Committee indicated that there may be practical issues related to filing amendments for periods audited by a predecessor auditor. The SEC staff replied that disclosures included in the financial statements are part of the audited financial statements and an independent accountant must report on those audited financial statements. The SEC staff further emphasized that a registrant should not conclude that a restatement is not required just because the error is immaterial in the current period when a large adjustment occurred several years ago. In providing any filing relief, the SEC staff expects transparency (e.g., an analysis in the notes to the financial statements of the amount of the cumulative restatement of beginning retained earnings, such as a schedule showing the amount attributable to each previous fiscal year).

The OCA letter can be accessed at the SEC's website at:

http://www.sec.gov/info/accountants/staffletters/fei_aicpa091906.htm

The guidance from the Division of Corporation Finance was subsequently issued in the form of a sample letter and can be found at:

<http://www.sec.gov/divisions/corpfin/guidance/oilgasltr012007.htm>

B. Division of Corporation Finance Update

Carol Stacey provided the following update of activities in the Division of Corporation Finance:

- **Staffing Update**

Parveen Gupta joined the SEC in August 2006 as the Academic Accounting Fellow and will serve a one-year term. Rachel Mincin is leaving the Division for a position in the Office of the Comptroller of Currency. Ms. Mincin's position is currently posted internally.

The Division has lost approximately 15 to 20 accountants recently and is hopeful to begin posting for new positions soon. The Division is considering reactivating its Professional Accounting Fellow program.

- **Reviews of Registrant Filings**

Division staff members are still in the process of reviewing 2005 10-K filings with the expectation of meeting internal deadlines (Sarbanes-Oxley mandates that the Division complete reviews of all public companies at least once every three years). The Division initially focused on larger companies and has started reviews of some smaller companies with the hopes of having any comment letters issued before the end of the year.

In large part, the issues that are raising comments are similar to those noted in previous reporting seasons. Carol Stacey provided the following summary of the most frequent issues raised in comment letters.

- *Classification Errors.* The SEC staff has observed that registrants often have difficulty assessing the materiality of classification errors in the statement of cash flows, primarily because SAB 99 is based on an income statement analysis.

Registrants need to go beyond SAB 99 and identify qualitative factors unique to cash flows when evaluating materiality. The SEC staff noted that “cash flow from operating activities” is an important metric to investors (often more important than net income).

- *Fair value issues.* Common issues include the determination and reasonableness of the methodology and assumptions used in determining fair value. The SEC staff noted that registrants often fail to identify and disclose key assumptions that are critical to fair value measurements. The SEC staff also noted that the AICPA “cheap stock” practice aid has helped IPO registrants in determining the appropriate valuation methodology and assumptions for their equity options issued.
- *Critical Accounting Estimates.* The Division is not issuing many comments regarding MD&A disclosures of critical accounting estimates, but this remains an area of focus and concern for the SEC staff. Certain industry groups have performed focused reviews on critical accounting estimates and it is expected that the next Accounting and Disclosures Outline will include guidance in that area.
- *Non-GAAP Measures.* Common issues include excluding recurring charges, specifically stock based compensation. Carol Stacey indicated that although the SEC staff doesn’t usually require amendments for non-GAAP measures, the presentation of a full non-GAAP income statement is not acceptable. The SEC staff observed that many registrants are not following the guidance set forth in the Frequently Asked Questions Regarding the Use of Non-GAAP Financial Measures (issued June 13, 2003), specifically question 8 regarding measures that exclude recurring items.

Another area of concern to the SEC staff relates to the presentation of non-GAAP measures on the basis that the measure is included in a registrant’s debt covenants. The SEC staff believes that disclosure of such a measure is appropriate in instances where the issuer is at risk of violating the covenant. However, the staff may question the relevance of such disclosure where it is clear there is no risk of violation.

- *Other Areas of Focus.* The SEC staff also has encountered the following recurring issues in recent reviews of filings:
 - 1) (in)appropriate application of hedge accounting, 2) correct classifications as debt or equity of convertible instruments and warrants, including consideration of EITFs 00-19 and 05-4) , 3) segment reporting (determination and aggregation of operating segments), and 4) revenue recognition (proper revenue recognition based on the terms and conditions of the sales agreement). With respect to the accounting for financial instruments under FAS 150, FAS 133 and EITF 00-19, the SEC staff indicated it is working with AcSEC as they develop guidance to assist registrants.

C. Enforcement Update

Susan Markel provided the following update of activities in the Division of Enforcement:

- **Staffing Update**

There have been no significant staffing changes since June and no new job postings.

- **Recent Enforcement Cases and Investigations**

Stock Option Investigations. There are currently over 100 active investigations on stock option related matters. Two cases, Brocade Communications Systems, Inc. and Comverse Technology, Inc., are currently in litigation.

Other issues. The Division continues to receive referrals from other divisions and whistleblowers. The Division continues to handle PCAOB related matters with the goal to coordinate, not duplicate.

III. STATUS UPDATE OF PROJECTS/ISSUES

A. Compilation of SEC Regulations Committee Meeting Highlights

In September 2005, the Committee provided the SEC staff with a copy of the draft compilation that incorporates joint meeting discussion documents from the 1994 to 2005 highlights. The draft compilation, which is organized by rule/regulation, contains numerous superseded discussion documents. The Committee indicated that it plans to reorganize the compilation to include only the issues, background and conclusion sections, together with links to the original meeting highlights. Superseded items would be maintained in a separate archived section. The SEC staff agreed with this approach.

B. Materiality

Following Staff Accounting Bulletin No. 108, the SEC staff is considering developing guidance about quantifying financial statement misstatements on a quarterly basis, considering the relevant recommendations of the SEC Advisory Committee on Smaller Public Companies, as well as the provisions of paragraph 29 of APB 28, *Interim Financial Reporting*.

The SEC staff indicated that it plans to address Staff Accounting Bulletin No. 108 at the AICPA SEC/PCAOB Conference in December 2006. SAB 108 states, "Correcting prior year financial statements for immaterial errors would not require previously filed reports to be amended. Such correction may be made the next time the registrant files the prior year financial statements." The SEC staff confirmed that, in cases like this where a pending restatement is immaterial, an Item 4.02 Form 8-K would not be required. However, the SEC staff cautioned that, if the error being corrected materially affected a prior quarter of the current fiscal year, the SEC staff would expect the registrant to file an Item 4.02 Form 8-K with respect to those interim financial statements.

C. Update of the *Staff Training Manual*

The SEC staff is making steady progress on finalizing an update of its *Staff Training Manual* and has completed drafting most sections. An expected completion date has not been set. The SEC staff is still considering whether the document should be made publicly available as interpretive guidance.

D. Alerts to be Issued by the Division of Corporation Finance or Office of the Chief Accountant

As discussed above, the Division of Corporation Finance noted that it might issue general guidance and identify additional factors registrants should consider in evaluating filings that require amendment as a result of stock option issues. The guidance might be in the form of an alert or letter.

E. Current Accounting and Disclosures Issues

The Division of Corporation Finance hopes to publish an update of its *Current Accounting and Disclosures Issues* in October 2006. The SEC staff indicated that no new significant items are expected to be included.

F. Status Update on Committee Documents Provided to the Staff

1. *Rule 3-10, 3-16 Task Force Discussion Documents*. Three discussion documents addressing the application of Rule 3-10 and Rule 3-16 were sent to the SEC staff on June 29, 2006. Based on a review of the documents, the SEC staff believes it would be most effective to schedule a separate meeting to discuss the issues with the Committee's Task Force. The Committee agreed to coordinate such a meeting with the SEC staff.

2. *Financial Statements of Credit Enhancers and Related Accountants' Consents in Filings by Asset-Backed Issuers*. A discussion document addressing the application of Regulation AB was sent to the SEC staff on July 31, 2006. The SEC staff indicated they agreed with the Committee's recommendation on the first of the two questions posed in the document (See Appendix B).

G. Division of Corporation Finance Preliminary Review of Filings

The SEC's Office of Inspector General issued a report on the Division of Corporation Finance's filing process entitled "Preliminary Review of Filings" (dated June 22, 2006) (see <http://www.sec.gov/about/oig/audit/2006/401fin.pdf>). The SEC staff made the following comments regarding this publication:

- In general, the SEC staff tries not to issue comment letters on calendar year end registrants in the October through December time frame. There may be unavoidable delays, however, that would cause an exception.

H. Recent GAO Report on Restatements

A recent GAO report on restatements observed that many companies did not file an 8-K under Item 4.02 (nonreliance on prior financial statements) to notify investors of a restatement of historical financial statements. Some simply filed 10-Qs or 10-Ks with this information. The GAO recommended that the SEC clarify/harmonize its rules so that the Item 4.02 8-K requirement is better understood. (The GAO report can be obtained at <http://www.gao.gov/new.items/d06678.pdf>). The SEC staff indicated that their position regarding the filing of a Form 8-K Item 4.02(a) has not changed and the determination by a registrant to file is one which requires judgment.

The SEC staff indicated that it is not pleased with the number of instances identified in the GAO report in which registrants apparently should have filed a Form 8-K Item 4.02(a). The SEC staff indicated that it is considering investigating these instances.

The SEC staff provided the following points of clarification regarding their views about when a Form 8-K Item 4.02(a) should be filed:

- If a number on the face of the financial statements changes in an amended filing, the SEC staff presumes that there is a restatement and investors should not rely on the prior financial statements. The Committee observed that financial statement line item changes might be immaterial changes. The SEC staff questioned why a registrant would amend a previous filing if the change is not material.
- Once the determination is made that a registrant needs to restate their financial statements, a Form 8-K Item 4.02(a) should be filed. A registrant should not include this information in another Exchange Act filing (e.g. Form 10-K, Form 10-Q), which investors might overlook, or

under another Item of Form 8-K. As discussed in Question 1 of the SEC staff's Form 8-K FAQs

(<http://www.sec.gov/divisions/corpfin/form8kfaq.htm>), the SEC staff believes all Item 4.02 events should be reported using Form 8-K.

- The SEC staff expressed concern over potential delays in reporting non-reliance conclusions under Item 4.02 and reiterated that Item 4.02(b) should be looked to by the auditor if they believe the company has not fulfilled their obligation under 4.02(a). The SEC staff questioned the process used by management, the auditor and the audit committee to resolve concerns about potential misstatements. The Committee responded that the process often requires the registrant to undertake significant analysis, as well as an evaluation of materiality, which can be time-consuming. In addition, as a matter of good corporate governance, the company's ultimate conclusion usually is based on discussions with the audit committee. Further, the Committee noted that if a registrant files a Form 8-K Item 4.02(a) prior to completing this process, there is a risk the ultimate conclusion might differ. The SEC staff reminded auditors that the 4.02 reporting is triggered when the party responsible for concluding on non-reliance has so concluded and that often does not include consultation with the audit committee.
- The Committee expressed their view that, if a registrant does not need to amend previously issued financial statements, there is no requirement for a Form 8-K Item 4.02(a) filing. As discussed above, the SEC staff confirmed that if there is an immaterial error in a prior year and the registrant waits until the next Form 10-K to correct it, a Form 8-K Item 4.02(a) filing is not required.

I. Testimony to Congress by Chairman Cox on September 6, 2006 Regarding Guidance on the Accounting Issues Surrounding Backdating

The SEC staff indicated that Chairman Cox recently testified before the United States Senate Committee on Banking, Housing, and Urban Affairs and Linda Thomsen, Director, Division of Enforcement, recently testified before the United States Senate Committee on Finance regarding stock option backdating practices. Other than the testimony publicly available, the SEC staff had no further comments.

The testimony of Chairman Cox and Linda Thomsen can be obtained at:

<http://www.sec.gov/news/testimony/2006/ts090606cc.htm>

and

<http://www.sec.gov/news/testimony/2006/ts090606lt.htm>

J. Practice Issues Related to PCAOB Q&A on Adjustments to Prior-Period Financial Statements Audited by a Predecessor Auditor issued on June 9, 2006

The SEC staff indicated that it has not received any questions or comments from the PCOAB or registrants regarding the Q&A.

K. Practice Issues Related to the Adoption of SFAS No. 123(R)

The SEC staff indicated that they have not received many substantive questions from issuers regarding the adoption of SFAS No. 123(R).

L. Status Update on approval of the September 2005, April 2006 and June 2006 Joint Meeting Highlights

The SEC staff noted it is compiling comments on the September 2005 and April 2006 highlights and expects to have revised drafts to the Committee in the next month. The SEC staff noted it has not started a review of the June 2006 highlights.

M. PCAOB Revisions to AS 2

The SEC staff indicated it was working with the PCAOB staff on the anticipated revisions to Auditing Standard No. 2. The SEC staff would not speculate on the expected timing of an exposure draft for public comment.

N. New Issuances/Releases

A list of final rules and notices of proposed rulemakings that were issued since the June 20, 2006 Joint Meeting with the SEC Staff is included at Appendix C.

IV. OTHER ISSUES

The following other issues were discussed with the staff.

A. Statement of Cash Flow Classification of Settlement of “In-Kind” Interest Instruments and Zero-Coupon Instruments

The SEC staff noted that a 2005 study by the Georgia Tech Financial Analysis Lab concluded, “when a company repurchases or redeems zero coupon bonds, it should classify the cash outflow for the repayment of principal amount received from bondholders as a financing use of cash and the amount paid in excess of the principal as operating use of cash.” However the study also concluded, “many companies are reporting the entire face amount paid for zero coupon bonds, including principal and interest, as a financing use of cash.” The SEC staff concurs with the study’s conclusions as the “technically correct” accounting answer. The SEC staff does not have an initiative to systematically comment on

the statement of cash flows classification of zero coupon and pay-in-kind interest instruments but believes that companies should consider whether their current classification complies with FAS 95.

The study can be accessed at the following URL:

http://mgt.gatech.edu/fac_research/centers_initiatives/files_finlab/ga_tech_cf_zero_2005.pdf

B. FASB Interpretation No. 48 (See Appendix A)

C. Definition of Worldwide Market Value

The Committee asked the SEC staff to clarify the definition of a registrant's "worldwide market value of the voting and non-voting common equity held by its non-affiliates" when a registrant does not have common equity registered in the United States. The SEC staff indicated that Exchange Act Rule 12b-2's definitions of accelerated filer and large accelerated filer are not intended to apply to an issuer with only debt registered in the U.S. The SEC staff indicated that the determination of worldwide common equity float is a legal determination, which registrants should discuss with their legal counsel. The SEC staff does not intend to issue any additional guidance in this area but indicated that if registrants have questions they should call Paul Dudek in the Division of Corporation Finance.

V. CURRENT PRACTICE ISSUES

The following emerging practice issues were addressed at the meeting and have been finalized in discussion documents that have been posted to the AICPA website. Click on the title to see the finalized discussion document.

- A. [Section 404 Reporting by Non-Accelerated Filers After Exiting Accelerated Filing](#)**
- B. [Rule 3-09 Financial Statements in the Year in which an Investee is Disposed \(Revisit of discussions from various prior meetings\) \(Discussion Document B from June '06 Meeting\)](#)**
- C. [Treatment in Pre-Adoption Pro Forma Income Statement of Options Given to Employees of a Target in a Business Combination after the Acquirer has Adopted Statement 123\(R\) \(Discussion Document H from June 20, 2006 Meeting\)](#)**
- D. [Labeling financial statement columns to indicate \(1\) a change in accounting principle, and \(2\) a correction of an error, as applicable](#)**

Disclosures under FASB Interpretation No. 48 in Form 10-Q in the Period of Adoption

Historically, the SEC staff has required that interim period financial statements filed on Form 10-Q that include the adoption of a new accounting standards in that interim period present all the disclosures required by the new standard. In addition, the SEC Staff has previously required that those disclosures continue to be provided in interim period financial statements filed on Form 10-Q subsequent to the quarter of adoption until the first annual financial statements are filed on Form 10-K after adoption that contain the required disclosures. (See, for example, Discussion Document E from the June 20, 2006 meeting.) FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, is effective in the first interim period for fiscal years beginning after December 15, 2006. Paragraphs 20 and 21 of FIN 48 establish a number of disclosures that are required on an annual basis. However, FIN 48 does not require (or permit) retrospective application. Accordingly, when a company first adopts FIN 48 in a quarter, it is unclear how to approach the initial disclosure of information that relates to annual periods.

Issue/Question:

What disclosures should be made by a public company in its Form 10-Q in the period of adoption?

The following is a list of the disclosure requirements under FIN 48. For each disclosure requirement please indicate if the disclosure is required (1) as of the date of adoption (i.e., those which must be included in all interim financial statements in the year of adoption), and (2) in interim periods post adoption, which would address interim balances or activity during the current and year-to-date interim periods. The Committee's recommendations are provided in the table below.

FIN 48 Disclosures	Disclosure as of date of adoption¹	Disclosure as to interim periods post adoption²
20. An enterprise shall disclose its policy on classification of interest and penalties in accordance with paragraph 19 of this Interpretation in the footnotes to the financial statements.	Yes⁴	Disclose any change in classification
21. An enterprise shall disclose the following at the end of each annual reporting period presented:		
a. A tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period, which shall include at a minimum:	Total amount of unrecognized tax benefits as of date of adoption	Tabular reconciliation not required for interim periods
(1) The gross amounts of the increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period	N/A	Disclose any material changes
(2) The gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during the current period	N/A	Disclose any material changes³
(3) The amounts of decreases in the unrecognized tax benefits relating to settlements with taxing authorities	N/A	Disclose any material changes³
(4) Reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations	N/A	Disclose any material changes³
b. The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate	Yes, amount of as of date of adoption	Disclose any material changes
c. The total amounts of interest and penalties recognized in the statement of operations and the total amounts of interest and penalties recognized in the statement of financial position ⁴	Total amount of accrued interest and penalties as of date of adoption	Disclose any material changes⁴
d. For positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date:	Yes, amount of as of date of adoption	Disclose any material changes⁵
(1) The nature of the uncertainty	Yes, as of date of adoption	Disclose any material changes
(2) The nature of the event that could occur in the next 12 months that would cause the change	Yes, as of date of adoption	Disclose any material changes
(3) An estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made	Yes, estimate of as of date of adoption	Disclose any material changes
e. A description of tax years that remain subject to examination by major tax jurisdictions.	Yes, as of date of adoption	Disclose any material changes

¹ Disclose in all interim financial statements in the year of adoption

² Regarding interim balances or activity during the current and year-to-date interim periods

³ If material amounts are recognized during the quarter, disclosure in management's discussion and analysis may be required.

⁴ See SEC Staff Position below regarding supplemental disclosures for interest and penalties in pre-adoption periods.

⁵ If material amounts are updated during the quarter disclosure in management's discussion and analysis may be required and critical accounting policies may need to be updated.

SEC Staff Position: The SEC staff agrees that this approach to disclosures is reasonable. In addition, registrants should consider the following disclosures regarding the classification of interest and penalties under paragraphs 20 and 21(c) of FIN 48.

Change in classification upon adoption:

If upon adoption of FIN 48, a registrant adopts a new financial statement classification of interest and penalties, it should disclose that it has adopted a new accounting principle and disclose its new policy for classification of interest and penalties. Because FIN 48 transition does not allow any form of retroactive application, financial statements for periods presented prior to adoption of FIN 48 should not be retroactively restated or reclassified to conform to the newly adopted accounting principle. However, a registrant should disclose its policy for the classification of interest and penalties for prior periods. Also, see “Other Implementation Questions” below regarding preferability.

Change in classification subsequent to adoption:

If subsequent to the first quarter of the year of adoption of FIN 48, a registrant changes its financial statement classification of interest and penalties, it should provide the disclosures specified by paragraphs 17 and 18 of FASB Statement No. 154, *Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3* (FAS 154) and file a preferability letter (post adoption). This change in accounting principle would be retrospectively applied beginning with the first interim period in which FIN 48 was applied. Periods prior to the adoption of FIN 48 should not be retroactively restated or reclassified, because FIN 48 transition does not allow retroactive application.

Additional disclosures for such changes in classification:

If a registrant has changed its classification policy, the SEC staff believes the registrant should disclose, in annual financial statements that include any period prior to the adoption of FIN 48, both the classification and amount of interest and penalties on uncertain income tax positions reflected in each income statement. In those circumstances, if the registrant cannot determine the amount of interest and penalties for periods prior to the adoption of FIN 48 due to its inability to disaggregate the interest or penalties portion of the accrual from the underlying tax exposure, it should disclose that fact.

Other Implementation Questions

Income statement classification of interest and penalties for income tax deficiencies under FASB Interpretation No. 48

Item 601(b)(18) of Regulation S-K requires a preferability letter for changes in accounting principles, except when the change is the result of the application of a new standard. Neither FASB Statement No. 109, *Accounting for Income Taxes*, nor FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, specifies how interest and penalties on income tax deficiencies should be classified. However, FIN 48 states that classification of these items is an accounting policy that requires disclosure.

Issues/Questions:

1. If a registrant changes its income statement classification of interest and/or penalties in connection with the adoption of FIN 48, is a preferability letter required?

Committee Recommendation: No. While technically such a change might represent an accounting change for which FAS 154 would require a registrant to establish preferability, the recognition and measurement attributes of tax positions (and possibly the related interest and penalties) may significantly differ under FIN 48 (resulting in potentially larger amounts of interest and penalties). Accordingly, the Committee believes it appropriate for a registrant to have a one-time “safe harbor” upon the adoption of FIN 48 to change its classification policy without establishing preferability.

SEC Staff Position: The SEC staff noted that acceptable alternatives to the income statement classification of interest and/or penalties on income tax contingencies existed prior to FIN 48 and continue to exist after FIN 48. However, after further consideration, because the accounting model for tax contingencies and interest has fundamentally changed, the SEC staff would not require justification of the change pursuant to paragraph 13 of Statement 154 or a preferability letter upon adoption of FIN 48.

2. If a registrant changes its income statement classification of interest and/or penalties after the adoption of FIN 48, is a preferability letter required?

Committee Recommendation: Yes

SEC Staff Position: After the adoption of FIN 48, the SEC staff agreed that a preferability letter is required for a material change in a registrant's accounting policy regarding the classification of interest and/or penalties on income tax contingencies.

Topic: Financial Statements of Credit Enhancers and Related Accountants' Consents in Filings by Asset-Backed Issuers

Background:

Regulation AB generally became effective for offerings of asset-backed securities initiated after December 31, 2005. For most asset-backed securities offerings, a sponsor registers the securities using Form S-3. Offerings registered on Form S-3 can be made on a delayed basis (i.e., a “shelf registration”), which would generally have a core prospectus that outlines the types of offerings that may be conducted in the future and a prospectus supplement that provides deal-specific information for each take-down. Many asset-backed securities issuances include credit enhancements provided in the form of financial guarantee insurance. This form of credit enhancement typically guarantees the timely payment of principal and interest on the securities issued should an event of default occur. Issuers obtain this credit enhancement in order to increase the credit rating, reduce interest costs and provide greater marketability to the transaction. The credit enhancement also provides the investor with greater marketability, secondary market price stability, and protection from loss associated with issuer default. There are a handful of entities in the U.S. that specialize in the financial guarantee business for asset-backed securities. This small group of entities guarantees numerous asset-backed securities issuances each year.

SEC Rules and Regulations

Regulation AB

Item 1114 of Regulation AB (§ 229.1114(b)(2)), *Credit enhancement and other support, except for certain derivatives instruments*, requires the inclusion of financial statements in Exchange Act filings (see specific discussion of Forms S-3 and 10-D below) meeting the requirements of Regulation S-X for any provider of credit enhancement or other support arrangements, including guarantees, if such entity or group of affiliated entities is liable or contingently liable to provide payments representing 20% or more of the cash flow supporting any offered class of asset-backed securities. The majority of financial guarantees provided on asset-backed securities issuances will meet this requirement.

Form S-3

For offerings of asset-backed securities on Form S-3, in addition to the items that are otherwise required, the issuer must furnish in the prospectus the information required by Items 1102 through 1120 of Regulation AB. Thus, guarantor financial statements will be required to be included in the Form S-3 if the Item 1114 test is met.

Form S-3 requires that all documents subsequently filed by the registrant pursuant to Sections 13(a), 13(c), 14 or 15(d) of the Exchange Act, prior to the termination of the offering, shall be deemed to be incorporated by reference into the prospectus. Form 10-D (discussed below) is a periodic report filed pursuant to Section 13 or 15(d) of the Exchange Act and thus is automatically incorporated by reference into a Form S-3. It should be noted that industry participants have indicated that many shelf registrations of asset-backed securities are terminated by the issuer a year or so after the effective date of the shelf registration statement.

Form 10-D

SEC Release No. 33-8518, *Asset-Backed Securities*, introduced a new periodic filing requirement for asset-backed securities issuances on Form 10-D. Filings on Form 10-D are required within 15 days after each required distribution date of the asset-backed securities (typically monthly). Item 7 of Form 10-D, *Significant Enhancement Provider Information*, requires the information in Item 1114(b)(2) to be provided. The instructions to Item 7 indicate that such information need only be provided in the report on the Form 10-D filed for the distribution period in which updated information regarding the enhancement provider is required pursuant to Item 1114(b)(2).

Item 1114(b)(2)(ii) states that if the credit enhancer “is liable or contingently liable to provide payments representing 20% or more of the cash flow supporting any offered class of the asset-backed securities” that it must “provide financial statements meeting the requirements of Regulation S-X (§§210.1-01 through 210.12-29 of this chapter)”.

Whether or not interim period information is required is not specifically addressed.

Asset-backed securities issuances – Pre-Regulation AB

Previously, in connection with a financial guarantee, the credit enhancer’s financial statements usually were not included or incorporated by reference in each respective asset-backed securities issuer’s Form S-3, and related core prospectus, at the effective date. The issuer does not usually contract for financial guarantee insurance until a take-down. Shortly before a take-down of the Form S-3 shelf registration, the asset-backed securities issuer usually would file a Form 8-K with the credit enhancer’s audited financial statements. The Form 8-K would be automatically incorporated by reference into the Form S-3 and core prospectus. The Form 8-K would include both the independent accountants’ report on the financial statements of the credit enhancer, as well as its consent to the incorporation and reference of that report into the registration statement and prospectus. The Form 8-K often also would be incorporated by reference into the prospectus supplement related to the shelf registration take-down, which might also refer to the independent accountants as experts.

The approach to incorporate the financial statements by reference, as opposed to including them in the registration statement and prospectus, has been the practice used by the issuers and credit enhancers as a result of no action letters from the SEC.

Asset-backed securities issuances – Post-Regulation AB

Following the effective date of Regulation AB, asset-backed securities continue to be registered on Form S-3, which now requires compliance with Item 1114(b)(2), if applicable, in the prospectus. As discussed above, practice continues that the issuer usually does not contract for financial guarantee insurance until a take-down. Usually, shortly before a take-down from the Form S-3 shelf registration, the asset-backed security issuer will file a Form 8-K with the credit enhancer’s audited financial statements, subject to the related consent requirements discussed above.

Subsequently, the asset-backed securities issuer is required to file a timely periodic report on Form 10-D that is automatically incorporated by reference into the shelf registration statement (Form S-3) if it remains effective. The Form 10-D is required to include the financial statements of the credit enhancer per Item 1114(b)(2), if applicable. In the initial Form 10-D, these financial statements will most likely be the same financial

statements that were filed in the Form 8-K and incorporated by reference into the Form S-3 and core prospectus.

When the credit enhancer issues updated audited annual financial statements (e.g., in its subsequent Form 10-K), the following Form 10-D filed by the asset-backed issuer is required to provide those updated financial statements (e.g., by incorporating them by reference from the credit enhancer's Form 10-K).

Question 1

When a Form S-3 shelf registration statement includes or incorporates by reference the credit enhancer's financial statements, when must a subsequent Form 10-D provide the credit enhancer's financial statements?

View A: The Exchange Act reporting requirement is separate from the Securities Act filing requirement. Accordingly, in order to comply with Item 1114(b)(2) of Regulation AB, the first Form 10-D filed after issuance of the asset-backed securities also must include or incorporate by reference the credit enhancer's financial statements. Whenever updated (new) financial statements are issued by the credit enhancer, those financial statements would also have to be provided in the next Form 10-D filed.

Question 1A: If View A is appropriate, is an auditor's consent required in the Form 10-D if the credit enhancer's financial statements provided in the Form 10-D are exactly the same as the financial statements included or incorporated by reference in the related registration statement?

View A1: Yes. If a Form 10-D contains audited financial statements and is incorporated by reference into a registration statement, the Form 10-D must include the auditor's currently dated consent to such incorporation. The requirement to provide such a consent is the same whether or not the financial statements contained in the Form 10-D are the same as financial statements already contained in the registration statement.

View A2: No. The auditor's consent is not required in a Form 10-D unless it contains audited financial statements that have been updated from those previously included or incorporated by reference in a registration statement. Under the SEC's 2005 securities offering reform, filing the Form 10-D with the same audited financial statements of the credit enhancer would not create a new effective date for the registration statement and no consent is needed.

View B: The reporting requirements of the Exchange Act and the Securities Act are integrated. Accordingly, presuming the Form S-3 includes or incorporates by reference the most recent audited financial statements of a credit enhancer, the next Form 10-D filed after the credit enhancer files *updated* (i.e., new) audited financial statements must include or incorporate by reference those audited financial statements. An issuer would not have to include a credit enhancer's financial statements in its first Form 10-D filed after issuance of asset-backed securities if those financial statements would be exactly the same as the credit enhancer's financial statements included or incorporated by reference in the registration statement.

Committee Recommendation: View B

SEC Staff Response: The SEC Staff agrees with View B.

New Issuances/Releases from June 20, 2006 to September 26, 2006

Final rules that have been issued since our last meeting (in reverse chronological order):

Executive Compensation and Related Person Disclosure

Internal Control Over Financial Reporting In Exchange Act Periodic Reports of Foreign Private Issuers That Are Accelerated Filers

Amendments to the Informal and Other Procedures; Public Company Accounting Oversight Board Budget Approval Process

Joint Final Rules: Application of the Definition of Narrow-Based Security Index to Debt Securities Indexes and Security Futures on Debt Securities

Fund of Funds Investments

Notices of Proposed Rulemakings that were issued since our last meeting:

Executive Compensation Disclosure (Request for Additional Comment)

Electronic Filing of Transfer Agent Forms

Internal Control Over Financial Reporting In Exchange Act Periodic Reports of Non-Accelerated Filers and Newly Public Companies

Amendments to Regulation SHO

Investment Company Governance (Request for additional comments)

Proposed Amendment to Rule 14a-8 under the Securities Exchange Act of 1934 concerning director nominating by shareholders

