U.S. Securities and Exchange Commission

Division of Corporation Finance
Current Accounting and Disclosure Issues

August 31, 2001

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U.S. Securities and Exchange Commission
Washington, D.C.

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Current Accounting and Disclosure Issues in the Division of Corporation Finance

August 31, 2001

I. Recent Rules, Proposed Rules and Interpretive Bulletins

A. Independence of Auditors and Related Proxy Disclosures

On November 15, 2000, the Commission voted to adopt new rules that modernize the requirements for auditor independence primarily in three areas:

- investments by auditors or their family members in audit clients;
- employment relationships between auditors or their family members and audit clients; and
- the scope of services provided by audit firms to their audit clients.

The new rules also require certain disclosures in annual proxy statements about fees paid for services provided by a company's independent accountant. The new rules reflect the Commission's consideration of comments received on the rules it proposed on June 30, 2000 (Securities Act Release No. 7870). On January 16, 2001, the staff published at www.sec.gov/info/accountants/audindep/audinfaq.htm frequently asked questions and answers about the independence rules and associated proxy disclosure requirements.

Significant features of the new rules

- The rules significantly reduce the number of audit firm employees and their family members whose investments in, or employment with, audit clients would impair an auditor's independence.
- They also identify certain non-audit services that, if provided to an audit client, would impair an auditor's independence. The rules do not extend to services provided to non-audit clients.
- A limited exception is provided to an accounting firm for inadvertent independence violations if the firm has quality controls in place and the violation is corrected promptly.
- Companies must disclose in their annual proxy statements certain information about non-audit services provided by their auditors during the last fiscal year.

Four Principles

A preliminary note to the new rules articulates four principles by which to measure an auditor's independence. An accountant is not independent when the accountant:

- has a mutual or conflicting interest with the audit client,
- audits his or her own firm's work,
- functions as management or an employee of the audit client, or
- acts as an advocate for the audit client.

Financial Relationships

Compared to the previous rules, the newly adopted rules narrow significantly the circle of people whose investments trigger independence concerns. Under the previous rules, many partners in firms that do not

work on the audit of a client, as well as their spouses and families, were restricted from investments in a firm's audit clients. The new rules limit restrictions to principally those who work on the audit or can influence the audit.

Employment Relationships

The employment relationship rules greatly narrow the scope of people within audit firms whose families will be affected by the employment restrictions necessary to maintain independence. The rules also identify the positions, namely those in which a person can influence the audit client's accounting records or financial statements, which impair an auditor's independence if held by a "close family member" of the auditor.

Business Relationships

Consistent with existing rules, independence will be impaired if the accountant or any covered person has a direct or material indirect business relationship with the audit client, other than providing professional services.

General Standard for Auditor Independence

The rule is based on the widely endorsed principle that an auditor must be independent in fact and appearance. The new rule specifies that an auditor's independence is impaired either when the accountant is not independent "in fact" or when, in light of all relevant facts and circumstances a reasonable investor would conclude that the auditor would not be capable of acting without bias. The "reasonable investor" standard is a common construct in securities laws.

Non-Audit Services

The rules identify nine non-audit services that are deemed inconsistent with an auditor's independence. Seven of the nine services were already restricted by the AICPA, SECPS or SEC. The new rules closely track the language found in the existing prohibitions.

- **Bookkeeping or Other Services Related to the Audit Client's Accounting Records or Financial Statements.** Paralleling closely the current prohibition on bookkeeping, an audit firm cannot maintain or prepare the audit client's accounting records or prepare the audit client's financial statements that are either filed with the Commission or form the basis of financial statements filed with the Commission. Exceptions include providing services in emergency situations, provided the accountant does not undertake any managerial actions or make any managerial decisions. Exceptions also include bookkeeping for foreign divisions or subsidiaries of an audit client, provided certain conditions exist.

- **Financial Information Systems Design and Implementation.** The auditor cannot operate or supervise the operation of the client's IT systems. However, the auditor can provide IT consulting services if certain criteria are met. These criteria specify that management must

- acknowledge to the auditor and audit committee management's own responsibility for the client's system of internal controls,
- identify a person within management to make all management decisions with respect to the project,
- make all the significant decisions with respect to the IT project,
- evaluate the adequacy and results of the project, and
- not rely on the accountant's work as the primary basis for determining the adequacy of its financial reporting system.

The prohibition does not include services an accountant performs in connection with the assessment, design, and implementation of internal accounting controls and risk management controls.

- **Appraisal or Valuation Services or Fairness Opinions**. The new rule bans all valuation and appraisal services. Its restrictions apply only where it is reasonably likely that the results of any valuation or appraisal would be material to the financial statements, or where the accountant would audit the results.

- **Actuarial Services**. Closely tracking the SECPS prohibition on actuarial services, actuarial-oriented advisory services are limited only when they involve the determination of insurance company policy reserves and related accounts. Certain types of actuarial services can be performed if the audit client uses its own actuaries or third party actuaries to provide management with the primary actuarial capabilities, management accepts responsibility for actuarial methods and assumptions, and the accountant does not render actuarial services to an audit client on a continuous basis.

- **Internal Audit Services**. An audit firm will be allowed to perform up to 40 percent (measured in terms of hours) of an audit client's internal audit work. The rule does not restrict internal audit services regarding operational internal audits unrelated to accounting controls, financial systems, or financial statements. The rule provides an exception for smaller businesses by excluding companies with less than $200 million in assets. Providing any internal audit services for an audit client, however, is contingent on management taking responsibility for and making all management decisions concerning the internal audit function.

- **Management Functions**. Consistent with previous SEC rules, an auditor's independence is impaired under the new rules when the accountant acts, temporarily or permanently, as a director, officer, or employee of an audit client, or performs any decision-making, supervisory, or ongoing monitoring function for the audit client.

- **Human Resources**. Closely paralleling the SECPS rules, an auditor is not permitted to recruit, act as a negotiator on the audit client's behalf, develop employee testing or evaluation programs, or recommend, or advise that the audit client hire, a specific candidate

for a specific job. An accounting firm can, upon request by the audit client, interview candidates and advise the audit client on the candidate's competence for financial accounting, administrative, or control positions.

- **Broker-Dealer Services**. Consistent with current AICPA rules, an auditor cannot serve as a broker-dealer, promoter or underwriter of an audit client's securities.

- **Legal Services**. An auditor cannot provide any service to an audit client under circumstances in which the person providing the service must be admitted to practice before the courts of a U.S. jurisdiction.

- **Contingent Fee Arrangements.** The rules reiterate that an accountant cannot provide any service to an audit client that involves a contingent fee.

- **Quality Controls.** The rules provide a limited exception from independence violations to the accounting firm, if certain factors are present:

    - The individual did not know the circumstances giving rise to his or her violation.

    - The violation was corrected promptly once the violation became apparent.

    - The firm has quality controls in place that provide reasonable assurance that the firm and its employees maintain their independence. For the largest public accounting firms, the basic controls must include, among others, written independence policies and procedures, automated systems to identify financial relationships that may impair independence, training, internal inspection and testing, and a disciplinary mechanism for enforcement.

- **Proxy Disclosure Requirement**

    - Companies must disclose in their annual proxy statements the fees for audit, I/T consulting and all other services provided by their auditors during the last fiscal year. Items 9(e)(1), (2) and (3) of Schedule 14A require that each of these amounts be provided under a specified caption. One way to satisfy this requirement is to provide a table consisting of two columns or rows, the first listing the three captions and the second listing the three amounts. Any further breakdown of the amounts is optional and could be included in the table itself, in a footnote to the table or in narrative disclosure in proximity to the table. The amount designated as audit fee must include only fees for financial statement audit and review services performed by the auditor that are customary under generally accepted auditing standards or that are customary for the purpose of rendering an opinion or review report on the financial statements.

- Companies must also state whether the audit committee has considered whether the provision of the non-audit services is compatible with maintaining the auditor's independence.

- The registrant is required to disclose also the percentage hours worked on the audit engagement by persons other than the accountant's full time employees, if that figure exceeded 50 percent. This requirement responds to recent moves by some accounting firms to sell their practices to financial services companies. The partners or employees often become employees of the financial services firm. The accounting firm then leases assets, namely auditors, back from those companies to complete audit engagements. In such cases, most of the auditors who work on an audit are employed elsewhere unbeknownst to the public.

- Item 9(e) of Schedule 14A does not specify where in the proxy statement the disclosures must appear. Many companies present together the disclosures required by Item 7(e) and Items 9(a)-(e) of Schedule 14A. However, the safe harbor in Item 7(e)(3)(v) of Schedule 14A applies only to information required to be disclosed under Item 7(e)(3) and the safe harbor in Item 306(c) of Regulation S-K applies only to information required to be disclosed by Items 306(a) and (b) of Regulation S-K and, therefore, neither safe harbor covers disclosures required by Item 9(e) but included in the audit committee report.

B. Revenue Recognition Guidance (SAB 101, 101A&B, and FAQ)

On December 3, 1999, the staff published Staff Accounting Bulletin 101 to provide guidance on the recognition, presentation and disclosure of revenue in financial statements (www.sec.gov/interps/account/sab101.htm). The SAB draws on the existing accounting rules and explains how the staff applies those rules, by analogy, to transactions that the accounting literature does not otherwise address specifically. On October 12, 2000 the staff published Frequently Asked Questions and Answers which responds to inquiries received from auditors, preparers and analysts about how the accounting literature and guidance in SAB 101 should be applied (www.sec.gov/info/accountants/sab101faq.htm).

SAB 101 identifies basic criteria that must be met before registrants can record revenue:

- persuasive evidence of an arrangement exists;
- delivery has occurred or services have been rendered;
- the seller's price to the buyer is fixed or determinable; and
- collectibility is reasonably assured.

In the absence of authoritative literature addressing a specific arrangement or a specific industry, the staff believes preparers and auditors should

assure that the company's revenue recognition policy satisfies all of these criteria.

Specific fact patterns discussed in the SAB include bill-and-hold transactions, long-term service transactions, refundable membership fees, contingent rental income, and up-front fees when the seller has significant continuing involvement. The SAB also addresses whether revenue should be presented at the full transaction amount or on a fee or commission basis when the seller is acting as a sales agent or in a similar capacity. Finally, the SAB provides guidance on the disclosures registrants should make about their revenue recognition policies and the impact of events and trends on revenue.

The Q&A provides additional interpretive guidance about the significance of title transfer, the meaning of substantial performance and customer acceptance, the effect of undelivered elements on nonrefundable payments, the conditions for recognition of refundable service revenue, and various SAB 101 implementation questions.

Registrants were expected to change their accounting policies to comply with the SAB. Provided the registrant's former policy was not an improper application of GAAP, registrants adopted a change in accounting principle to comply with the SAB no later than the last fiscal quarter of the fiscal year beginning after December 15, 1999.

C. Materiality in the Preparation or Audit of Financial Statements (SAB 99)

On August 12, 1999, the staff published Staff Accounting Bulletin No. 99. The SAB expressed the staff's view that exclusive reliance on certain quantitative benchmarks to assess materiality in preparing or auditing financial statements is inappropriate. The SAB states that the staff has no objection to the use of a percentage threshold as an initial assessment of materiality, but exclusive use of such thresholds has no basis in law or in the accounting literature. The staff stresses that evaluations of materiality require registrants and auditors to consider all of the relevant circumstances, and that there are numerous circumstances in which misstatements below a benchmark percentage threshold could be material.

The SAB also notes that even though a misstatement of an individual amount may not cause the financial statements to be materially misstated, it may, when aggregated with other misstatements, render the financial statements taken as a whole to be materially misleading. The SAB, therefore, provides guidance on when and how to aggregate and net misstatements to evaluate whether they materially misstate the financial statements. The SAB advises that, even if management and auditors find that a misstatement is immaterial, they must consider whether the misstatement results in a violation of the books and records provisions in Section 13(b) of the Exchange Act.

D. Restructuring Charges, Impairments, and Related Issues (SAB 100)

On November 24, 1999, the staff published Staff Accounting Bulletin No.

100, which provides guidance on the accounting for and disclosure of certain expenses and liabilities commonly reported in connection with restructuring activities and business combinations, and the recognition and disclosure of asset impairment charges. Generally, costs that may be recognized solely pursuant to management's plan to incur them are limited under GAAP to those costs which result directly from an exit activity, are not associated with and do not benefit continuing activities, and for which there is appropriate authorization, specification, and commitment to execute. The SAB expresses the staff's view that a company's exit plan should be at least comparable in its level of detail and precision of estimation to the company's other operating and capital budgets, and should be accompanied by controls and procedures to detect and explain variances and adjust accounting accruals. The SAB discusses disclosures in financial statements and MD&A that are often necessary to make the effects of restructuring activities on reported results sufficiently transparent to investors. Registrants are referred to EITF 94-3 and 95-3 for specific disclosures that should be included in financial statements for the period of the initial restructuring charge and for subsequent periods while the plan is being implemented.

SAB 100 also reminds registrants that the operational requirement to continue to use an asset disallows accounting for the asset as "held for sale." If the asset is held for use, its carrying value must be systematically amortized to its salvage value over its remaining economic life. If management contemplates the removal or replacement of assets more quickly than implied by their depreciation rates, the useful lives of the assets and rates of depreciation must be re-evaluated.

The SAB explains the staff's concern if a registrant records liabilities assumed in a business combination at amounts materially greater than historically reported by the acquired company. That circumstance could indicate that costs incurred before or after the merger were not properly recognized in the reported results of one or the other combining company. The SAB reminds registrants that, if the acquired company's historical accounting for a liability is based on reasonable estimates of undiscounted future cash flows, the estimated undiscounted cash flows underlying the liability recorded by the acquiring company would not be expected to differ materially from those estimates unless the acquirer intends to settle the liability in a manner demonstrably different from that contemplated by the acquired company.

E. Selected Loan Loss Allowance and Documentation Issues (SAB 102)

On July 6, 2001, the staff published Staff Accounting Bulletin (SAB) No. 102, which provides certain views of the staff about the development, documentation, and application of a systematic loan loss allowance methodology. The Commission previously issued guidance on this topic in December 1986 through Financial Reporting Release No. 28 (FRR No. 28). The SAB applies to registrants that are creditors in loan transactions that, individually or in the aggregate, have a material effect on the registrant's financial statements. The SAB does not change any of the accounting profession's existing rules on accounting for loan loss provisions or allowances.

The staff views in the SAB are based on the premise underlying FRR No. 28: loan loss estimates developed without a disciplined methodology or adequate documentation can undermine the credibility of an institution's financial statements. Since the issuance of FRR No. 28, the Commission's staff has continued to observe, from time to time, a lack of discipline in the establishment of allowances for loan losses and situations in which companies may have weaknesses in their documentation related to loan loss allowances. The General Accounting Office has made similar observations about the loan loss allowance practices of depository institutions, as it reported in its October 1994 Report to Congressional Committees, *Depository Institutions: Divergent Loan Loss Methods Undermine Usefulness of Financial Reports*. The SAB provides guidance to registrants to assist them in improving both their systematic methodologies for estimating loan loss allowances and their supporting documentation.

SAB No. 102 covers several topics, including the following:

- A summary of current loan loss allowance guidance under generally accepted accounting principles and Commission rules and interpretations;
- General factors or elements to consider in developing and documenting loan loss allowance methodologies, including in written policies and procedures;
- Staff expectations for documenting loan impairment under FASB Statements No. 114 and No. 5;
- Staff expectations related to summary documentation of the results of a systematic loan loss allowance methodology; and
- General guidance on validating, and documenting the validation of, a systematic loan loss allowance methodology.

The SAB was prepared as a result of the March 10, 1999 Joint Interagency Letter to Financial Institutions signed by the SEC, the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision. In that Joint Letter, the agencies agreed to provide parallel guidance on loan loss allowance methodologies and supporting documentation. The banking agencies issued their parallel guidance on July 6, 2001 through the Federal Financial Institutions Examination Council as interagency guidance, "Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions."

F. Proposed Rule for Disclosure About Valuation and Loss Accruals, Long-Lived Assets

On January 21, 2000, the Commission proposed rule amendments to reposition certain schedule information about valuation and loss accruals that is currently required in exhibits to certain periodic reports and registration statements. (Securities Act Release No. 33-7793) Under the proposed rule, this information would be required by new Item 302(c) of Regulation S-K and be included within the main body of reports and

registration statements. Also, a proposed new Item 302(d) of Regulation S-K would require certain information concerning tangible and intangible long-lived assets and related accumulated depreciation, depletion, and amortization. Amendment of Form 20-F is also proposed to include new Item 8C soliciting identical information in filings by foreign private issuers. The rule proposals are intended to provide investors with (1) more transparent, better detailed disclosures concerning changes in valuation and loss accrual accounts and in the underlying accounting assumptions, and (2) more detailed information to assess the effects of useful lives assigned to long-lived assets.

Under the proposed rule, registrants would be required to provide beginning and ending balances and additions to and deductions from accounts established for each major class of valuation or loss accrual. Examples of accounts for which the disclosure would be required include allowances for doubtful trading accounts or notes receivable; allowances for sales returns, discounts and contractual allowances; unamortized discount or premium; excess of estimated costs over revenues on contracts (losses accrued under SFAS 5); liabilities for costs of discontinued operations; liabilities for exit and employee termination relating to a restructuring or business combination; contingent tax liabilities recorded under SFAS 5; product warranty liabilities, and probable losses from pending litigation. Disclosures provided in response to this item would not be audited, and would not be duplicated if they are presented in the financial statements.

Similarly, the proposed rule would require provision of unaudited information depicting beginning and ending balances and additions to and deductions from accounts established for each major long-lived asset classification and its corresponding accumulated depreciation, depletion and amortization account. Major long-lived asset classifications are those for which separate presentation is made on the balance sheet and include land, buildings, equipment, leaseholds, brand names, non-compete agreements, customer lists, and goodwill.

G. Disclosure of Equity Compensation Plan Information

As the use of equity compensation, particularly stock options, has increased in recent years, so too have concerns about the impact of these programs. These concerns involve (a) the absence of full disclosure to security holders about equity compensation plans, (b) the potential dilutive effect of these plans and (c) the adoption of many plans without the approval of security holders.

In Release No. 33-7944, dated January 26, 2001, the Commission proposed amendments that would require registrants to disclose, at least annually, information about the total number of securities that have been authorized for issuance under each equity compensation plan in effect as of the end of the last completed fiscal year, whether or not the plans have been approved by security holders. This disclosure would be set forth in a tabular format

- in the registrant's proxy statement whenever the registrant is seeking security holder action regarding a compensation plan; or

- in the registrant's annual report on Form 10-K in years when the

registrant is not seeking security holder action regarding a compensation plan.

These amendments would require disclosure in a registrant's proxy statement or annual report on Form 10-K or 10-KSB of the following information:

- the number of securities authorized for issuance under each equity compensation plan of the registrant in effect as of the end of the most recently completed fiscal year;
- the number of securities issued pursuant to equity awards made during the last completed fiscal year, plus the number of securities to be issued upon the exercise of options, warrants or rights granted during the last completed fiscal year, under each plan;
- the number of securities to be issued upon the exercise of outstanding options, warrants or rights under each plan; and
- other than securities to be issued upon the exercise of outstanding options, warrants or rights, the number of securities remaining available for future issuance under each plan.

This information would be provided without regard to whether the equity compensation plan was previously approved by a registrant's security holders. Registrants would be required to identify, either in the table or through a narrative statement, which of the equity compensation plans, if any, was adopted without security holder approval. They also would be required to provide a brief, narrative description of the material features of each plan adopted without security holder approval during the last completed fiscal year. The comment period on the proposed rule ended April 2, 2001.

H. Guarantors and Issuers of Guaranteed Securities

On August 24, 2000, the Commission adopted rules concerning the financial statements and Exchange Act reporting requirements for subsidiary guarantors and subsidiary issuers of guaranteed securities (Securities Act Release No. 7878). These rules include revisions to Rule 3-10 of Regulation S-X and new Rule 12h-5 under the Exchange Act. The rules supercede Staff Accounting Bulletin 53 (SAB 53).

The amendments to Rule 3-10 codify the staff's current positions as articulated in SAB 53 and the interpretive positions that the staff has taken with respect to SAB 53, with one principal difference. The rule does not permit the presentation of summarized financial information in lieu of separate financial statements of a subsidiary issuer or guarantor. Rather, it requires condensed consolidating financial information in all situations where SAB 53 permitted summarized financial information.

Amended Rule 3-10 retains the general requirement that each subsidiary issuer or guarantor must file the same financial statements specified by Regulation S-X for a registrant. It then identifies exceptions where more limited financial information is permitted. To qualify for an exception, the

guarantee must be full and unconditional, the subsidiary must be 100% owned by its parent company, the parent company must file consolidated financial statements meeting the requirements of Rules 3-01 and 3-02 of Regulation S-X, and the parent company's consolidated financial statements must include condensed consolidating financial information reflecting in separate columns the parent company, the subsidiary issuer (s), the subsidiary guarantors(s), any non-guarantor subsidiaries, consolidating adjustments, and the consolidated totals. This information is required in the registration statement and in the parent company's subsequent annual and quarterly reports under the Exchange Act. In certain limited cases, narrative disclosure about the guarantees is permitted in lieu of the condensed consolidating information. These limited circumstances include "plain vanilla" finance subsidiary issuers guaranteed solely by the parent company, and parent company issuers with no independent assets or operations where all direct and indirect subsidiaries included in the parent company's consolidated financial statements, other than minor subsidiaries, are guarantors. Narrative disclosure in lieu of condensed consolidating financial information is not permitted in circumstances where SAB 53 previously permitted summarized financial information, unless the conditions in the preceding sentence are met. The exceptions described above also apply to parent companies and subsidiaries that co-issue debt, provided that all other qualifying conditions are met.

Amended Rule 3-10 includes specific requirements applicable to recently acquired guarantors. If a significant recently acquired guarantor has not been included in the parent company's consolidation for at least nine months, one year of audited pre-acquisition financial statements of that guarantor is required in any registration statement for guaranteed securities. A recently acquired guarantor is significant if the greater of its pre-acquisition net book value or purchase price exceeds 20% of the principal amount of the securities being registered. Financial statements of recently acquired guarantors are not required in periodic reports under the Exchange Act.

New Rule 12h-5 exempts from Exchange Act reporting any subsidiary issuer or guarantor permitted by Rule 3-10 to omit financial statements. Thus Rule 12h-5 eliminates the need for subsidiary issuers or guarantors to request exemptive or no-action relief from Exchange Act reporting.

The rule revisions did not change the financial statement requirements for affiliates whose securities are pledged as collateral for a registered security, but those requirements have been relocated to new Rule 3-16 to distinguish them from the subsidiary issuer and guarantor requirements. Revisions to Item 310 of Regulation S-B clarify that the requirements of amended Rule 3-10 and Rule 3-16 apply to small business issuers. Appendices to the adopting release provide implementation guidance regarding the 100%-owned test, the identification of the parent company, and the financial statement requirements for recently acquired guarantors.

The rules became effective September 25, 2000. Registrants that have existing Exchange Act reporting obligations with respect to guaranteed securities must apply the new rules beginning with their annual report for their first fiscal year ending after September 25, 2000.

I. Recent Enforcement Actions Involving Financial Statements

1. Enforcement actions involving Sunbeam Corporation

On May 15, 2001, the Commission filed a civil injunctive action in U.S. District Court charging 5 former officers of Sunbeam Corporation and the former engagement partner on the Arthur Andersen LLP audits of Sunbeam's financial statements with fraud. The Commission also instituted settled administrative proceedings against Sunbeam and its former General Counsel, who, without admitting or denying the Commission's allegations, consented to the entry of cease-and-desist orders prohibiting future violations of specified provisions of the securities laws.

The Commission's complaint in the injunctive action alleges that senior management of Sunbeam, led by its CEO and CFO, engaged in a fraudulent scheme to create the illusion of a successful restructuring of Sunbeam and thus facilitate a sale of the Company at an inflated price. According to the complaint, the defendants employed a laundry list of fraudulent techniques, including creating "cookie jar" revenues, recording revenue on contingent sales, accelerating sales from later periods into the present quarter, and using improper bill and hold transactions. The complaint states that an engagement partner at Arthur Andersen, Sunbeam's outside auditing firm, authorized unqualified audit opinions on Sunbeam's 1996 and 1997 financial statements although he was aware of many of the Company's accounting improprieties and disclosure failures. For more information, see Accounting and Auditing Enforcement Release No. 1393.

2. Enforcement actions involving Waste Management, Inc.

On June 19, 2001, the Commission brought settled enforcement actions against Arthur Andersen LLP and four of its current or former partners in connection with Andersen's audits of the annual financial statements of Waste Management, Inc. for the years 1992 through 1996. Those financial statements, on which Andersen issued unqualified opinions, overstated Waste Management's pre-tax income by more than $1 billion. As alleged in the Commission's complaint and found in a related Commission order, Andersen knowingly or recklessly issued materially false and misleading audit reports on Waste Management's annual financial statements.

Andersen settled both a civil injunctive action charging violations of antifraud provisions of the federal securities laws, and related administrative proceedings finding that the firm had engaged in improper professional conduct. Without admitting or denying the allegations or findings, Andersen agreed to the first antifraud injunction in more than 20 years, and largest-ever civil penalty -- of $7 million -- in an SEC enforcement action against a Big Five accounting firm. Andersen further agreed to be censured under the SEC's rules of practice.

Three Andersen partners also settled both the civil injunctive action, which also charges them with violations of antifraud provisions of the federal securities laws, and related administrative proceedings. A fourth Andersen partner, a regional practice director, settled administrative proceedings finding that he had engaged in improper professional conduct. Without admitting or denying the allegations, the three partners each agreed to the entry of an antifraud injunction and to the payment of a civil penalty, and all four agreed to a bar from appearing or practicing before the Commission as an accountant for specified periods.

As alleged in the Commission's complaint or found in its related administrative order: In each of the years 1992 through 1996, the Andersen engagement team identified a variety of improper accounting practices. Andersen failed to quantify many of the non-GAAP accounting practices that it identified, and did not include them in its estimate of the effects of all known and likely misstatements identified by the audit. In connection with the audit of Waste Management's 1993 financial statements, Andersen proposed a series of "Action Steps" to change the practices only in future periods and to write off the company's prior misstatements over a five- to seven-year period, rather than require immediate correction. In many instances, the Company did not implement the Action Steps and continued to utilize accounting practices that did not conform with GAAP. In other cases, the Company offset misstatements and other expenses against gains while making no disclosure of the netting. Andersen told Waste Management that its use of netting was an "area of SEC exposure," but nonetheless allowed Waste Management to, in Andersen's own words, "bury" the charges. For more information, see Accounting and Auditing Enforcement Release No. 1405.

II. Other Current Accounting and Disclosure Issues

A. Disclosure, Accounting and Auditing Alerts

In a letter to Arleen Thomas of the AICPA, dated October 13, 2000, the Commission's Chief Accountant, Lynn Turner, identified a wide assortment of current disclosure, accounting and auditing issues that financial managers, auditors and audit committees should consider. Topics included in his letter that are addressed elsewhere in this outline include: revenue recognition and SAB 101; segment disclosures; FAS 133's accounting rules for derivatives and hedging; intangible assets; advertising costs; loan loss accounting and disclosure; auditor association with interim financial statements; and the equity method of accounting. Some other items addressed in Lynn Turner's letter are summarized below. Look to the letter itself for a more complete discussion of these issues (www.sec.gov/info/accountants/staffletters/audrsk2k.htm.

1. The expected impact of recently issued accounting standards should be disclosed, as discussed in SAB 74 (Topic 11:M). Disclosure should be considered with respect to any newly issued accounting guidance that comprises GAAP as specified by SAS 69.

2. Stock compensation accounting was modified by FIN 44. Reductions of an employee's stock option exercise price, either directly or indirectly, now subject the option to variable plan reporting from the date of the modification to the date of award, forfeiture or expiration. Also, registrants are reminded that awards of equity instruments to nonemployees should be valued realistically. If equity instruments are issued to customers at less than fair value, EITF 96-18 and 00-14 require companies to reduce product or service revenue in the amount of the discount in the same periods and manner as if a sales discount had been granted.

3. Convertible securities issued within one year of an IPO with beneficial conversion terms compared to the IPO price are presumed to result in additional compensation or other expense to the extent of the

difference between the IPO price and the conversion price. The registrant may rebut the presumption by presenting sufficient, objective, verifiable evidence supporting its fair value. The staff may request information about valuations that the underwriter discussed with senior management or the board of directors.

4. Income statement classification is very relevant to today's users of financial statements who are evaluating the quality of recurring revenues and expenses. The requirements of Regulation S-X should be observed. The EITF also provided recent guidance about classification: Issue Nos. 99-17 (barter), 99-19 (gross v. net), 00-10 (shipping & handling), 00-14 (coupons, rebates & discounts).

5. MD&A too frequently reports only the changes in historical reported amounts, without sufficient explanation of the reasons, or the necessary discussion of significant uncertainties and consideration of whether reported trends and financial relationships can be expected to continue. Some current developments that should be addressed, if applicable, are: foreign currency transactions; increasing fuel prices and interest rates; risks of exposures to highly leveraged entities; and financial reporting effects of employee pension and other post retirement plans caused by changes in the market value of plan assets or conversions to cash balance plans.

6. Accounting changes that must be retroactively implemented but are not material to prior period financial statements are addressed in SAB 5F. The cumulative effect of the change may be included in the income statement in the period that the change is made unless the cumulative effect is material to that period.

7. Changes in accounting estimates must be accompanied by the disclosures specified in paragraph 33 of APB 20. Robust discussion of the expected impact of the changes in estimate should also be included in MD&A.

8. Income tax shelters must meet the requirements of paragraph 33 of FAS 109 to justify non-recognition of the associated deferred tax liability. All disclosures required by paragraph 44 of FAS 109 should be provided.

9. International accounting and auditing issues that have been noted by the staff are: errors in the home-country GAAP financial statements disclosed only as items in the US GAAP reconciliation, rather than corrected in the primary financial statements; use of the cost method to account for subsidiaries and investees that are erroneously considered "immaterial;" failure to adjust an investee's local GAAP financial statements to the basis of accounting in the primary financial statements in applying the equity method; excessive time lags between the financial statements of the investor and investee in applying the equity method; failure to observe the US GAAP consolidation guidance found in EITF 96-16 and 97-2; failure to observe the significant influence criteria found in FIN 35; and failure to obtain Rule 3-09 financial statements and Rule 4-08(g) complete summarized data. Final rules on international disclosure standards have been adopted and can be found at www.sec.gov/rules/final/34-