



BDO Seidman, LLP
Accountants and Consultants

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Assessing the Quality of Financial Reporting in 2003

For the U.S. financial and capital markets, 2003 was a turnaround year. Both businesses and investors exhibited cautious and progressively stronger optimism, as regulators toiled to turn the tide of accounting mischief and provide the markets with the foundation for increased trust and transparency in financial reporting. Signs of renewed vitality emerged, and the year ended on a strong uptick with the markets registering gains. But the gains were hard-won, and they mask an unprecedented array of complexities that can add to the challenges of sound financial reporting.

A Year of Hard-Won Gains

The myriad of complexities confronting businesses in 2003 included an unpredictable economy, major political upheaval in parts of the world, and multifaceted profit pressures in many sectors. For companies that raise capital in U.S. markets, the added pressures of more vigilant investors and rating agencies, tougher penalties, and tighter reporting deadlines all combined to compound an already tough business environment.

If there is a golden rule for financial reporting in these difficult times, it is to abide by the spirit as well as the letter of accounting standards. Admittedly a lofty ideal, this approach may take a period of adjustment for some because it leaves more room for interpretation and it demands considerable discipline and professional judgment. Recent accounting pronouncements have taken steps to help companies apply the needed judgments to a wide range of transactions. But the effects on the quality of financial reporting remain to be seen, and the evaluation of that quality is becoming a priority in boardrooms across America and around the world.

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Recognizing the challenges of the changing landscape, BDO Seidman has focused this letter around a series of questions that can help managers and directors assess the quality of their company's financial reporting and ensure that potentially problematic situations associated with recent events and trends are fully addressed.

Key Questions Raised by Recent Events and Trends

Answers to the most challenging questions about the quality of financial reporting have always demanded a solid grasp of accounting standards. This year, an up-to-date understanding is especially important.

To help test your company's preparedness and response to recent changes in accounting standards, you may wish to use the following questions for discussions among the audit committee, management, and the company's auditors, then ask yourself what more can be done to ensure your company has successfully mastered the art of complying with the spirit as well as the letter of the accounting standards.

Do the financial statements consolidate the right entities, assets and liabilities?

At the top of the list are questions about consolidation practices. The sudden demise of Enron Corporation brought the risks of special-purpose, off-balance-sheet entities into the public eye, and the Financial Accounting Standards Board (FASB) responded in 2003 with new guidance on consolidation.

FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*,

was intended as an interpretation of the existing accounting literature, but it succeeded in introducing a revolutionary new concept of consolidation for a wide range of business entities known as variable interest entities (VIEs).

VIEs are entities that share one of the following two organizational traits: (1) the equity owners have invested so little that the entity needs subordinated financial support in some other form to finance its operations, or (2) control of the entity or significant risks and rewards of ownership rest with parties other than equity owners.

These two characteristics help define the expression "VIE," and they explain why a hidden relationship with this type of entity can be cause for concern.

In effect, a VIE affects companies that hold an interest in it in ways that vary with its own success (or failure), and this interest often takes a form, such as a contractual arrangement, that is more complex than a simple equity stake. These arrangements may make good business sense, but the inherent risks and opportunities can be tough to communicate through historical accounting conventions that tie consolidation to ownership of a majority of outstanding voting shares.

Serious and systematic evaluations

After studying the issues associated with off-balance-sheet entities, the FASB concluded there are many more potentially misunderstood entities than the types of special purpose entities (SPEs) involved in Enron's melt-down. The aim of Interpretation 46 was to encourage companies and auditors to think seriously and systematically about whether or not each of these entities should be consolidated.

The entities to be evaluated include corporations, partnerships, limited liability companies and trusts. Because Interpretation 46 casts such a wide net and raised many questions in the relatively short timeframe before its scheduled effective date, the FASB later relaxed some of the requirements. In December 2003, the Board issued a revised Interpretation that delayed the effective date of the original Interpretation and revised it to provide grounds for excluding entities, such as operating joint ventures and franchisees, from the scope of the Interpretation.

Grounds for excluding entities

The revised guidelines for judging the need to consolidate business entities that are VIEs require that companies compare their entities to the definition of a business provided in Emerging Issues Task Force (EITF) Issue No. 98-3, *Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business*.

Entities that meet the definition of a business in Issue No. 98-3 typically use such inputs as long-lived assets, intellectual property, and employees. These entities generally should be evaluated for possible consolidation using the traditional majority-voting-interest framework, unless one of the following conditions exist: (a) the holder of a variable interest was involved in their formation or design, (b) substantially all the activities of the entity involve or are conducted on behalf of the holder, (c) the holder provides more than half the entity's subordinated financial support, or (d) the entity's activities relate to certain forms of financing or leasing arrangements.

Room to exercise leadership

Admittedly, the guidelines provided in revised Interpretation 46 (known as Interpretation 46R) are not “bright-line” tests, meaning they are not as black-and-white as a test for 51% of the ownership of outstanding stock. But the gray areas leave room for companies to exercise leadership in selecting more conservative applications of the Interpretation and in choosing to apply the guidance as early as possible within the timeframe permitted by the FASB.

Applying FASB Interpretation 46R

For *public companies*, one deadline is ironclad: They are required to consolidate their interests in special purpose entities (SPEs) in year-end 2003 financial statements. (Interpretation 46R defines SPEs within the context of prior EITF decisions. Specifically, SPEs are defined as entities covered by the guidance in Issues No. 90-15, 96-20, 97-1, or Topic D-14.)

For interests in other types of VIEs, public companies have some flexibility in their 2003 financial reporting. If they have already applied Interpretation 46, they can apply the revised Interpretation or, in some cases, depending on the date the VIE was created, can choose between the original or the revised Interpretation. For VIEs that predate the issuance of original Interpretation 46 to which the Interpretation had not yet been applied, they are permitted to wait until the first quarter of 2004.

Private companies also face an ironclad deadline in that they must apply revised Interpretation 46 to VIEs created after December 31, 2003 from the date of the company's first involvement. For VIEs created prior to that date, private companies have more time to do the

needed evaluations and calculations, but they must apply the revised Interpretation to these entities no later than the beginning of the first reporting period beginning after December 15, 2004.

For additional information about Interpretation 46, please see our *Financial Reporting Letter, New Accounting Rules for VIEs – aka SPEs*.

Do the financial statements properly record and fully disclose any contingent liabilities for guarantees or warranties?

Contingent liabilities are widespread in today's business environment, and they have come under increased scrutiny in recent years. Studies of the trends in financial restatements filed with the SEC show a significant increase in the number of restatements involving reserves and contingencies.

In fact, the identification of errors in accounting for reserves and contingencies has become so prevalent that these mistakes were found to be the leading cause of restatements in 2003.

Several accounting pronouncements and an SEC release have addressed contingencies in the past two years. FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guaranties, Including Indirect Guarantees of Indebtedness of Others* was issued in late 2002, and SEC Release No. 33-8182, *Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations*, was issued in January 2003.

Examinations of contracts

Just as Interpretation 46 requires companies to seriously and systematically examine a wide range of entities for possible consolidation,

Interpretation 45 requires them to examine a wide range of contracts to assess the need for liability recognition or disclosure.

Although there are exceptions, the types of contracts that need to be examined generally include: (a) financial guarantees (that is, contingent obligations that are triggered by a change in a financial benchmark, such as a specified interest rate), (b) performance guarantees (that is, contingent obligations triggered by another entity's failure to perform under an agreement, such as a construction completion agreement), (c) indemnification agreements (that is, contingent obligations triggered by changes related to another entity's financial position, such as an adverse interpretation of a tax law), and (d) indirect guarantees of the indebtedness of others (such as an agreement to advance funds if another company's working capital falls below a specified minimum).

The identification of these contracts may take a thorough search, because they can include agreements embedded in existing commercial arrangements. A common example is a seller's guarantee of a customer's financing arrangements in conjunction with the sale of goods or services.

Applying FASB Interpretation 45

Once found, the contracts must be evaluated to see if they require the recognition of a liability or if disclosures will suffice. The types of guarantees requiring only disclosure include certain types of product warranties and guarantees with affiliated companies. Examples include intellectual property infringement indemnifications and a parent company's guarantee of a subsidiary's debt.

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If recognition of a liability is required, the liability must be recognized at the time the guarantee is made for the fair value of the obligation undertaken in making the guarantee. This accounting treatment is required for all guarantees subject to the Interpretation and issued or modified after December 31, 2002. It represents a significant change from previous accounting standards that required recognition of a liability only if and when a loss was probable.

Matters of judgment

The required use of fair values for contingent obligations will raise difficult valuation issues. Few of these guarantees have readily determinable market values. Many are unique and proprietary and entered as part of larger transactions.

Additional judgment will likely be required to determine when the guarantor is released from the obligation and how to account for that release. The Interpretation notes three methods of adjusting the liability are used in practice: (a) reverse the liability only on the expiration or settlement of the guarantee, (b) assume ratable release from the obligation and reverse the liability by a systematic and rational amortization method, or (c) use a mark-to-market basis in which the obligation is revalued and adjusted for subsequent changes in value.

To help companies apply the proper accounting treatment, the FASB has clarified that method (c) is acceptable only if supported by existing accounting standards. In the absence of specific guidance permitting mark-to-market accounting, companies will need to use judgment to select either method (a) or (b), depending on the particular facts and circumstances.

Because the accounting for contingencies involves so many matters of judgment, it represents another key opportunity for companies to take leadership positions in the quality of their financial reporting through their selection of accounting methods and use of more robust disclosures.

Disclosures by public companies

Minimum narrative disclosure requirements for public companies are provided in Release 33-8182, which requires SEC registrants to provide a comprehensive explanation of their off-balance sheet arrangements in the Management Discussion and Analysis section of their reports.

For additional information about Interpretation 45, please see our *Financial Reporting Letter Year in Review - Significant 2002 Financial Reporting Developments*. For further discussion of SEC Release 33-8182, please see our *Financial Reporting Letter MD&A Checklist*.

Do the financial statements properly reflect securities with characteristics of both liabilities and equity?

Investors and analysts have become concerned about accounting tactics that obscure their understanding of future cash flows. These concerns often center on earnings because of the perception that the quality of a company's earnings depends on the extent to which the earnings consist of cash (rather than noncash) components.

However, the concerns also extend to other accounts that affect key ratios, (such as return on equity and debt-to-equity). A prime example is the possible misclassification of financial instruments with characteristics of both liabilities and equity.

As a stopgap measure, in 1979 the SEC issued Accounting Series Release No. 268 requiring that public companies classify equity securities outside of shareholders' equity, if the securities carry future cash obligations that are outside the issuer's control. The SEC expected that the FASB would issue comprehensive guidance clarifying the distinction between equities and liabilities. While awaiting FASB action, the SEC staff periodically issued additional guidance to clarify the accounting treatment for these types of instruments, most recently in EITF Topic D-98, *Classification and Measurement of Redeemable Securities*.

Shares with future cash obligations

In May 2003, the FASB stirred up a storm of controversy by extending a requirement similar to the SEC's rules to both public and private companies.

FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, changed the accounting for financial instruments in situations where a company is obligated to issue or redeem shares of its own stock in two important respects: First, the instruments must be classified as liabilities rather than as equity or in the "mezzanine" section of balance sheets where they were formerly permitted. Second, payments to the holders must be recorded as interest expense, rather than dividends, and changes in value must be recorded in earnings. Statement 150 is the first step of a more comprehensive reconsideration of the proper classification of financial instruments on the right side of the balance sheet.

Storm of controversy

Small businesses protested the Statement's provisions and its rela-

tively short transition period because of the effects on their ratios. A key concern was that the accounting treatment would place them in violation of loan covenant agreements or cause them to be unfairly shut out of business opportunities in certain regulated industries or with state and local governments.

Others voiced concerns about the provisions that call for noncontrolling interests in limited-life entities, such as partnerships, to be treated as mark-to-market liabilities in the consolidated financial statements.

Deferrals and decisions

The FASB responded to the concerns about Statement 150 through a series of revisions that relax and defer portions of the Statement, and in some cases prohibit early adoption. The bottom line is that companies are left with a number of choices to make while the FASB continues to discuss the issues as part of its larger project.

The choices affect some but not all the instruments for which Statement 150 provides guidance. These instruments are: (a) mandatorily redeemable shares, (b) freestanding written put options and forward contracts that obligate an entity to purchase its own shares, and (c) freestanding contracts that obligate an entity to pay with its own shares in amounts that are either unrelated, or inversely related, to the price of the shares.

Adopting Statement 150

The provisions of the Statement that were deferred, along with the restrictions on early adoption, are as follows:

- For *public companies*, early adoption is prohibited for the provisions that were deferred indefinitely

related to noncontrolling interests in consolidated financial statements. These provisions relate to interests deemed mandatorily redeemable only because the issuing entity has a limited life. A more limited deferral applies to other types of mandatorily redeemable noncontrolling interests created before November 5, 2003.

- *Private companies* have until fiscal periods beginning after December 15, 2004 to apply the standard to shares that are mandatorily redeemable on fixed dates for amounts that are fixed or determinable. The requirements are deferred indefinitely for other mandatorily redeemable shares issued by these companies.

Interim guidance

The interim guidance in effect during the deferral period affords companies some flexibility to exercise leadership in making decisions. The general rule in cases where Statement 150 does not apply, is that instruments should be carried on the balance sheet at their fair value as of the date of issuance and adjusted or disclosed at subsequent balance sheet dates, as appropriate, depending on the probability (or risk) of redemption. Topic D-98 provides the following guidance:

- If a security is currently redeemable, its carrying value should be adjusted to its redemption value at each balance sheet date.
- If the security is not currently redeemable but future redemption is probable, the SEC staff has indicated they will not object to either of two approaches.
 - Adjusting the carrying amount at each balance sheet date as if the security were currently redeemable.

- Adjusting the carrying amount on a systematic and rational basis to the estimated redemption amount at the earliest redemption date.

- If the security is not currently redeemable and future redemption is not deemed probable, then subsequent adjustment is not required until it is probable the security will become redeemable. Until then, the company should disclose the reason why it is not probable the security will become redeemable.

Extending the golden rule

The thinking behind the SEC's interim guidance provides helpful advice for companies grappling with a variety of accounting situations involving judgment or multiple interpretations. Simply stated, a corollary to the golden rule of complying with the spirit as well as the letter of the standards is to make more detailed disclosures, especially about items thought to influence the quality of a company's earnings or the reliability of its ratios.

For additional information about Statement 150, please see our *Financial Reporting Letter FASB Statement No. 150 Brings Big Changes*.

Do the financial statements account properly for revenues in arrangements with bundled products and services?

The Number 1 cause of restatements in 2002, errors in revenue recognition, dropped to the Number 2 spot in 2003 filings with the SEC. But the drop masks wide variations by size of company. Among companies with annual revenues under \$100 million, almost half (49%) were caused by errors in revenue recognition. Vigilant investors are especially

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concerned with any disconnect between revenues and cash, such as may be present in sales involving a bundling of products and services in arrangements known as sales with multiple deliverables.

Multiple deliverables

The EITF stepped up to the challenge of providing guidance on the accounting for arrangements with multiple deliverables in EITF Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*. So difficult and complex were the underlying issues that it took several years to achieve a full consensus.

The final consensus became effective for fiscal periods beginning after June 15, 2003 for most companies, with early application permitted. Its guidance addresses questions that have arisen from a broad and growing business trend that spans multiple industries. Examples of arrangements with multiple deliverables include the sale and subsequent installation of a machine or the sale of a product with a lifetime service contract.

Uncertainties and probability estimates

The upshot of the EITF's consensus is that companies with arrangements with multiple deliverables will need to make liberal use of probability estimates in accounting for these arrangements. Key steps in the accounting include: (1) separating the revenues from the various deliverables in a multi-element arrangement, (2) determining the total consideration of an arrangement that provides for refunds or returns in certain conditions, and (3) allocating the total consideration to the various units of accounting.

- *Separating the revenues.* The first step is to evaluate each of the elements to determine if they

can be divided into separate units of accounting with their own revenue streams. The general rule for an arrangement consisting of a delivered item, along with undelivered items and a right of return, is that the items should not be treated as separate units of accounting unless the answers to all the following questions are affirmative:

- For the delivered item: Does it have value to the customer on a standalone basis? The EITF has indicated a yes answer would be appropriate if the item is routinely sold separately in the marketplace by another vendor, or might be resold by the customer on a standalone basis.
- For any undelivered item(s): Is there objective and reliable evidence of its fair value?
- For any general right of return relative to the delivered item: Is the delivery or performance of the undelivered item(s) considered probable and substantially in the control of the seller?
- *Determining the total consideration.* When determining the total consideration of an arrangement that provides refunds or returns in certain conditions, the key is to find the total that is fixed and determinable, except for any refund rights or performance bonuses to which the seller may be entitled.
- *Allocating the revenues.* If there is objective and reliable evidence of fair value for all units of accounting in an arrangement, the revenues should generally be allocated to the separate units based on their relative fair values. An alternative method called the residual method is used for situations in which there is objective

and reliable evidence of fair values only for the undelivered items.

Layers of complexities

The accounting standard for arrangements involving multiple deliverables illustrates the level of complexity that is increasingly part of the discipline of accounting. In effect, there are three layers.

The base layer consists of the complexities that result from the use of probability estimates, along with the questions that can arise in assessing the objectivity and reliability of fair values.

The next layer consists of complexities inherent in the sophisticated agreements made by companies to manage their business and maintain flexibility in uncertain economic times.

For example, some companies are making increased use of revenue arrangements that are contingent on the delivery of an undelivered item. The application of Issue No. 00-21 to these situations can result in allocating zero revenue to the delivered item, raising questions about whether the related costs should be deferred – an issue on which the EITF has decided not to provide guidance.

The final layer arises from the interaction of accounting standards, since Issue No. 00-21 applies only if there is no higher-level guidance in the hierarchy of accounting literature. As a result of this principle, a number of common sales arrangements require practitioners to study the interaction between multiple standards.

Examples of revenue arrangements that involve multiple standards include combinations of multiple deliverables and outsourcing, as well as the bundling of software with nonsoftware deliverables. In

response to questions that have arisen, the EITF indicated in EITF Issue No. 03-5, *Applicability of AICPA Statement of Position 97-2 to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software*, that non-software deliverables included in arrangements bundled with software should be accounted for in accordance with Issue No. 00-21 rather than the specific accounting rules (AICPA Statement of Position (SOP) No. 97-2) that apply to software revenue recognition.

Broad applicability

Although Issue No. 00-21 may appear to address a relatively narrow area of accounting, the guidance has broad applicability and provides a good starting point for discussion and evaluation of revenue recognition practices. As part of their search for arrangements with multiple deliverables, diligent companies might probe the nature of any contingencies related to sales transactions, such as rights of return or refund, the existence of any side agreements or post-sale obligations, and the nature of any sales involving extended financing terms or noncash consideration.

Do the financial statements recognize costs associated with restructurings in the right period?

As an inevitable byproduct of the recent economic downturn, another wave of corporate restructurings emerged, with companies shedding excess facilities and staff to streamline operations and manage for maximum flexibility.

Although statistics show the U.S. economy has recovered in some respects, employment has been a lagging indicator. As layoffs have continued in some industries, questions have continued to arise about

when and how to report restructuring charges.

The FASB addressed these questions in Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. This Statement was effective for exit or disposal activities initiated after December 31, 2002. It covers a wide range of costs associated with downsizings, including lease termination costs and certain employee severance costs that are associated with a restructuring, discontinued operation or other exit or disposal activity.

Statement 146 specifically excludes costs to terminate capital leases, costs associated with the restructuring of an entity newly acquired in a business combination, termination benefits provided to employees under the terms of an ongoing benefit arrangement (or related enhancement), and individual deferred compensation contracts covered by other accounting standards.

Changes in timing

A restructuring is defined for accounting purposes as a program that is planned and controlled by management and materially changes the manner in which the business is conducted. Examples include changing the management structure, moving business activities to another location, closing the business activities in a particular location, closing down a line of business, and reorganizing in ways that fundamentally change the nature and focus of a company's operations.

In prior years, companies were required to accrue restructuring costs when management approved and made a commitment to a downsizing plan. Statement 146 changes this to prohibit the accrual of costs until liabilities to outside

parties are actually incurred, even if the costs are incremental to other operating costs and will be incurred as a direct result of the plan.

Matters of judgment

If restructuring costs include termination benefits when downsizing the number of employees, judgment is required to determine if the layoffs are part of a one-time benefit arrangement rather than part of an ongoing plan (or an enhancement to one). A key factor to consider is whether the potential enhancement will continue to be applicable for future workforce reductions.

If the determination is made that the downsizing is part of an ongoing plan or an enhancement to one, the general rule is that recognition of a liability is required when the payment of benefits is probable and the amount can be reasonably estimated. (For details, see FASB Statement Nos. 5, 43 and 112).

Judgment is also required to determine the proper accounting treatment for future rent under an operating lease for an asset that the company will not use. These costs generally are defined as costs that will continue to be incurred under the contract for its remaining term without economic benefit to the reporting entity. An example would be lease rentals that will continue after office space is vacated.

Questions that arise in applying the spirit as well as the letter of the accounting standard include whether a liability should be recognized when a company vacates one of several floors in the same office building. Management's intent is an important part of the equation, because a liability should be recognized only when the company permanently ceases using leased space that is functionally independent.

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For further discussion of Statement 146, please see our *Financial Reporting Letter Accounting for Costs Associated with Exit or Disposal Activities*.

Do the financial statements reflect other-than-temporary losses on investments in marketable securities?

As the U.S. capital markets swung from bull market to bear market and back to bull market over the past few years, regulators of capital markets have intensified their scrutiny of the accounting for marketable securities.

The FASB's accounting for marketable securities hinges on a system of classifications that depends to a large extent on: (1) assessments of management's intent (for example, whether management intends to hold debt securities until maturity), and (2) the duration of any decline in value along with expectations about the recovery of that decline in value. Both these factors entail subjectivity and risk.

Classification by management intent

Under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, debt securities that a company has the positive intent and ability to hold to maturity are reported at amortized cost, with the result that earnings are not affected by temporary increases or decreases in value.

Sales of these securities before maturity are expected to be rare and can cast doubt on management's credibility and jeopardize the accounting for similar securities in the future. An exception is provided for a significant deterioration in the issuer's creditworthiness, provided the deterioration affects one security rather than a portfolio of securities.

Other securities are classified as trading securities (if management intends to sell them in the near future), or available for sale (if they don't fall into either of the other two categories).

Depending on which category a security falls into, the designation of a decline in its value as "other-than-temporary" can have important accounting consequences.

Other-than-temporary declines

If a decrease in the value of a security classified as available for sale or held to maturity is considered "other-than-temporary," the security must be written down to fair value with the loss included in income, and the charge cannot be reversed later if the market value of that security recovers.

Despite these serious consequences, the term "other-than-temporary" is not defined in the accounting literature, and it can be subject to considerable judgment in a prolonged bear market such as the U.S. capital markets experienced in recent years.

In 2003, the EITF formed a working group to study the issue. The EITF has not yet reached a full consensus on Issue 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. But it reached a partial consensus in November 2003 that requires enhanced disclosures about securities subject to Statements 115 and 124.

Starting with financial statements for fiscal years ending after December 15, 2003, companies must disclose in their financial statements the aggregate amounts of unrealized losses broken down by investment type and the length of time the investments have been in an unrealized loss position, (less than one year and one year or

more). If investments have been in an unrealized loss position for one year or more and the impairment is considered temporary, the company is required to discuss the reasons why.

No safe harbor for public companies

Notwithstanding the time periods selected by the EITF for the disclosure requirements, the SEC staff has indicated that there is no "safe harbor" based on the length of time the declines in value have existed. Declines that have existed for more than one year are not automatically considered other-than-temporary, and declines of less than one year are not automatically considered temporary. However, the EITF observed that the longer a decline persists, the greater the burden of proof on the investor to demonstrate that the decline is temporary.

Because of the level of judgment involved in this area, management and audit committees of public companies should discuss any unrealized losses and ensure the financial statements comply with the spirit of the accounting standard.

Disclosures for governmental entities

The Governmental Accounting Standards Board has also adopted a system of fair-value accounting for most investments, since investments often represent significant and mission-critical assets of governmental funds.

To ensure that financial statement users are fully informed about risks that could affect a government's ability to provide services and meet its obligations as they become due, the GASB issued Statement No. 40, *Deposit and Investment Risk Disclosures, an amendment of GASB Statement No. 3*, in March 2003.

This Statement sets additional disclosure requirements for investments with fair values that are highly sensitive to changes in interest rates. It also requires disclosure of investment policies related to a number of risks, including credit and interest rate risks.

Do the financial statements adequately address pension obligations and other factors needed for top-quality financial reporting?

The combination of lower stock prices and interest rates prompted securities analysts to issue a flurry of reports in recent years calling for increased scrutiny of pension accounting and its potential effects on the quality of a company's earnings and future cash flows.

The FASB responded by revising Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits*, in December 2003. The revised standard adds disclosure requirements about plan assets, investment policies, benefit obligations, key assumptions, and the measurement date used to determine the pension and other postretirement benefit measurements that make up at least a majority of plan assets and obligations. It also establishes requirements for disclosures in interim financial statements.

Applying Statement 132R

In effect, Statement 132R provides a roadmap of sorts for analysts and investors, who had previously found it difficult to locate the information needed for their analysis.

Most of Statement 132R's disclosure requirements for domestic plans of public companies take effect in 2003 annual financial statements. The requirements for

disclosures by public companies about estimated future benefit payments and non-U.S. plans take effect for fiscal years ending after June 15, 2004. Nonpublic companies must make all the annual disclosures for fiscal years ending after June 15, 2004. The interim disclosure requirements will take effect with quarterly reports for the first quarter of 2004.

Addressing other factors

Accounting standard-setters issued a multitude of additional guidance to address the many other factors needed for top-quality financial reporting. Following are highlights of a few of the pronouncements that affect financial reporting in 2003.

- **FASB Staff Positions.** The FASB introduced a new type of pronouncement called a FASB Staff Position (FSP). The guidance from several FSPs has been incorporated in the prior topics in this Letter.

Another significant FSP released this year, FSP FAS 106-1, requires interim disclosures about the effects of the Medicare Prescription Drug, Improvement and Modernization Act of 2003. This Act provides a subsidy to encourage employers to maintain retiree health care benefits in the face of rising costs. Under FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, employers are required to estimate the effects of changes in law on their accumulated postretirement benefit obligation in the year of enactment.

However, recognizing the burden of estimating the effects of a complex law for which regulations have not yet been issued, the FASB provided an optional

deferral period. The FASB plans to issue guidance on accounting for the effects of the Act in 2004. In the meantime, the FSP establishes disclosures requirements that apply during the deferral period.

- **Other FASB developments.** The FASB also released guidance on a number of emerging issues and subjects on which there is diversity in practice. Among other topics, the guidance addresses the following:
 - *Cash balance plans.* A cash balance plan is a form of defined benefit pension plan that has some attributes of a defined contribution plan. EITF Issue No. 03-4, *Determining the Classification and Benefit Attribution Method for a "Cash Balance" Pension Plan*, provides guidance on measuring the projected benefit obligation for certain types of cash balance plans. The FASB plans to address the accounting for cash balance plans more broadly in 2004.
 - *Leases.* The EITF established criteria for determining whether an arrangement should be considered a lease for accounting purposes (Issue No. 01-8). New guidance was also provided for the accounting by lessors for arrangements involving third-party guarantees of the expected residual value of portfolios of leased property. Examples include certain guarantees obtained by automobile leasing companies. (For details, see the announcement made by the SEC Observer in EITF Topic D-107.)
 - *Derivatives and hedging.* In 2003, the FASB issued Statement No. 149, *Amendment of Statement 133*

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on *Derivatives Instruments and Hedging Activities* to clarify which instruments meet the definition of a derivative and provide guidance to ensure that all derivatives are treated consistently in the financial statements. Guidance was also released on prepaid interest rate swaps and accounting for the discontinuance of hedging relationships as a result of changes in consolidation practices under Interpretation 46. (See DIG Issues A23 and E22 for details.)

- **AICPA's Statements of Position.**

The Accounting Standards Executive Committee of the American Institute of Certified Public Accountants issued several industry-specific Statements of Position (SOPs).

- SOPs 03-4 and 03-5. These SOPs provide guidance on presenting financial highlights for nonregistered investment partnerships and insurance company separate accounts.

- SOP 03-3. This SOP provides guidance on the accounting for loans or certain debt securities acquired in a transfer if the obligor's credit has deteriorated. It updates the guidance in AICPA Practice Bulletin 6.

- SOP 03-1. This SOP provides guidance on accounting by life insurance enterprises for certain nontraditional long-duration contracts. It takes a position on when the assets and liabilities of contracts should be presented as separate accounts for accounting purposes.

- **GASB developments.** Several important developments affect

the quality of 2003 financial reporting by state and local governments.

- GASB *Statement No. 34*. Major changes take effect for smaller government entities in 2003 in accordance with the transition schedule for Statement 34, *Basic Financial Statements – and Management's Discussion and Analysis – State and Local Governments*. This Statement creates new information and restructures much of the information that governments have presented in the past in an effort to make annual reports more comprehensive and easier to understand and use.

- GASB *Technical Bulletin 2003-1*. This Bulletin established new disclosure requirements for derivatives not reported at fair value on the Statement of Net Assets. The requirements are effective for financial statements for years ending after June 15, 2003.

- *Other GASB Statements*. Several new standards were issued and became available for early adoption in 2003. GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, establishes requirements related to assets that are impaired. (A capital asset is considered impaired when its service utility has declined significantly and unexpectedly.) GASB Statement No. 39, *Determining Whether Certain Organizations are Component Units*, provides guidance on when certain organizations should be considered component units. Statement 40, mentioned earlier in this Letter, establishes new disclosure

requirements for deposits and investments.

For a complete listing of recent accounting pronouncements and their effective dates, see the reference materials attached to this letter.

Are more accounting changes in store for 2004?

Companies can expect more accounting changes in 2004. Important changes have been proposed by all three accounting standard-setters – FASB, GASB and AICPA. And more proposals for sweeping changes are expected in the coming year.

The FASB's convergence proposals

In December 2003, the FASB issued four exposure drafts designed to help achieve convergence with standards set by the International Accounting Standards Board.

- *Areas affected.* The areas affected by these proposed standards are: accounting changes and error corrections, inventory costs, earnings per share, and exchanges of productive assets. Although these appear to be relatively narrow areas of accounting, the changes could be significant for some companies, if adopted as proposed.

- *Restatements.* The FASB's proposal on accounting changes and error corrections would require companies to retroactively apply changes, including changes caused by new accounting standards, unless the standard provides different transition guidance. A key obstacle to acceptance of this proposal is the fact that restatements tend to be viewed negatively by investors and securities analysts. To help overcome that obstacle for public

companies, the SEC's chief accountant has promised to help ensure investors understand that restatements can occur for a variety of reasons, and not all the reasons are bad.

- *Other proposals.* Among the more significant changes that would be effected by the other proposals are the following: (1) companies that experience abnormal amounts of idle capacity and spoilage would be required to expense the costs related to these items, (2) companies that exchange similar productive assets, such as warehouse space, would need to recognize a gain based on the fair values of the assets, unless the exchange lacks economic substance, and (3) calculations of earnings per share would be modified in several ways, including a requirement to include common shares issuable upon the conversion of mandatorily convertible securities in the denominator of basic earnings per share.
- *More to come.* The FASB expects to issue a fifth proposal in early 2004 to address classification of debt due on demand due to violation of covenants.

Equity-based compensation

In another project designed to achieve convergence with IASB standards, the FASB plans to issue a proposal to change the accounting for equity-based compensation in early 2004. For public companies, the changes will likely be slated to take effect in calendar year 2005 financial statements. The major change would be a requirement for expensing the fair value of employee stock options. This proposal is expected to be controver-

sial. Legislators and others have publicly challenged the wisdom of mandatory expensing of broad-based employee stock options.

AcSEC's proposals

The AICPA's Accounting Standards Executive Committee (AcSEC) released a proposed SOP on *Allowance for Credit Losses* in June 2003. AcSEC also has several proposals scheduled for release in 2004 that are likely to result in important accounting changes. The subjects include:

- Accounting for real estate time-sharing transactions.
- Scope of *Investment Companies Guide*.
- Accounting by insurance enterprises for deferred acquisition costs on certain internal replacements.
- Capitalization of certain costs and activities related to property plant and equipment. The final SOP on property, plant and equipment may result in significant changes that affect all types of companies, including not-for-profit organizations and regulated entities.

The GASB's proposals

The GASB had several proposals outstanding at the end of 2003, including two exposure drafts on accounting for postemployment benefits other than pensions (OPEB). A revised exposure draft on employers' accounting for OPEB was released in early 2004.

A separate proposal issued by the GASB in 2003 addresses the statistical section of the annual financial statements and would require that this section be updated to reflect changes in governmental reporting and finance.

Six Techniques to Help Improve the Quality of Financial Reporting

As compliance with the spirit rather than simply the letter of the standards has become a priority for management, audit committees and other governing bodies in the post Sarbanes-Oxley era, the growing need to apply judgment in financial reporting presents both risks and room for leadership.

To exercise leadership and avoid the risks, management and audit committees can take the following steps:

1. Ensure the adequacy and training of your company's accounting and financial reporting talent.

The volume, complexity and interaction of today's multitude of accounting standards add pressures that demand constant attention and continuing education. The need to ensure adequate accounting talent is especially critical for public companies as they gear up for coming requirements for auditor reporting on the company's controls over financial reporting, because a key element of internal controls is having accounting personnel who understand the principles that form the basis for financial reporting.

2. Take a proactive role in discussing the quality, not just the acceptability, of the company's accounting principles with its auditor.

For public companies, Statement on Auditing Standards No. 90, *Audit Committee Communications*, requires discussions of these matters with the audit committee. Private companies may

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wish to request a similar discussion. Examples of the topics to be discussed include:

- Selection of new (or changes to) accounting policies.
- Estimates, judgments, and uncertainties.
- Unusual transactions.
- Accounting policies relating to significant financial statements items.
- The timing of transactions and the period in which they are recorded.

3. Understand how users of financial statements assess the quality of earnings. Although quality of earnings is not the same thing as quality of financial reporting, an understanding of the former can help ensure clear and complete disclosures. Factors affecting the quality of earnings generally involve income from non-cash sources, subjectivity or use of estimates, and inclusion of items that are nonrecurring. Relevant sources of information may include reports by securities analysts and rating agencies, as well as general press coverage of the company's performance and financial condition.

4. Beef up disclosures for areas involving greater judgment and risk. In addition to meeting the minimum requirements set forth by the standards, companies should consider the need for more robust disclosures about any areas involving interpretation, judgment or estimates that can affect earnings or key ratios. Examples drawn from recent

accounting developments include contingencies, pension and postretirement benefit obligations, revenues from arrangements with multiple deliverables, and securities with other-than-temporary losses in value. To identify other examples, management and directors should be prepared to probe the full range of factors mentioned in SEC Release 33-8350, *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations*. These factors include trends, demands, commitments, events and uncertainties, key performance measures, liquidity, capital resources, and critical accounting estimates.

5. Think of controls and consistently high quality financial reporting as a source of competitive advantage. There is an old saying that those who do not study history are condemned to repeat it. It is clear that a common denominator in the recent rash of accounting scandals has been a tendency to look to the estimates and judgment involved in the discipline of accounting as a way to structure transactions or report results that give a rosier picture than the economic substance of transactions would otherwise warrant. As these cases go to trial, they serve as vivid reminders of how accounting mischief can compromise the reputations of both companies and managers. These reputations may not be reflected on balance sheets, but they are valuable

sources of competitive advantage that affect future cash flows.

6. Combine accounting with business knowledge, and be prepared to ask the tough questions. The key to strengthening your company's reputation for excellence in financial reporting is to ask not, "How can accounting flexibility be used to improve results?" but rather, "How can we use accounting flexibility to provide a clearer picture of the company's financial condition and results of operations?" Through the use of sound judgment in making any changes in accounting principles, companies can avoid giving investors, analysts and others the perception that their reserves and contingencies are actually "rainy-day" or "cookie-jar" reserves. If you are unsure of the reasons for decisions, here are a few tough questions worth asking:

- How close did the company come to violating loan covenants or other contractual commitments, missing targets set for bonus purposes, or missing earnings expectations?
- Were there any last-minute adjustments to reserves or contingencies, non-recurring or related party transactions?
- What are there reasons for any apparent disconnects between the company's performance and industry or economic averages?

For Further Information

The following publications provide more details about the accounting events and trends mentioned in this letter. They are available on BDO's web site at <http://www.bdo.com/about/publications/assurance>.

- FASB Statement No. 150 Brings Big Changes
- New Accounting Rules for VIEs – aka SPEs
- Year in Review - Significant 2002 Financial Reporting Developments
- MD&A Checklist
- Accounting for Costs Associated with Exit or Disposal Activities
- Accounting for Indexed PoweredSM CDs Under Statement 133
- FASB Issues Guidance Regarding the Application of Statement 133 to Loan Commitments
- Restoring Accountability

If you would like further information or to discuss the implications of the matters discussed in this *Financial Reporting Letter*, please contact the BDO Seidman engagement partner serving you or one of the following partners: Ben Neuhausen or Wayne Kolins.

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Listing of Recent Pronouncements

This Financial Reporting letter provides highlights of significant developments that affect a broad spectrum of business enterprises. For a more in-depth look at the recent developments that affect your specific industry sector, you may wish to review this detailed listing of recent pronouncements and the scheduled effective dates on Table 2. These materials can help identify other topics for discussion with management, audit committees and auditors.

Type of Pronouncement	Title and Date of Issuance
FASB Statements	
Statement 132 (Revised 2003).	Employers' Disclosures about Pensions and Other Postretirement Benefits. (Issued: December 2003.)
Statement 148.	Accounting for Stock-Based Compensation - Transition and Disclosure. (Issued: December 2002.)
Statement 149.	Amendment of Statement 133 on Derivative Instruments and Hedging Activities. (Issued: April 2003.)
Statement 150.	Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity. (Issued: May 2003.)
FASB Interpretations	
Interpretation 45.	Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others. (Issued: November 2002.)
Interpretation 46. (Revised 2003).	Consolidation of Variable Interest Entities (Revised 2003). (Issued: December 2003.)
Interpretation 46.	Consolidation of Variable Interest Entities. (Issued: January 2003.)
FASB Staff Positions (FSPs)	
FSPs Related to Interpretation 46	
FSP FIN 46-1.	Applicability of FIN 46 to entities subject to the AICPA Audit and Accounting Guide, <i>Health Care Organizations</i> . (Released: July 24, 2003.)
FSP FIN 46-2.	Reporting Variable Interests in Specified Assets of Variable Interest Entities as Separate Variable Interest Entities under Paragraph 13 of FASB Interpretation No. 46, <i>Consolidation of Variable Interest Entities</i> . (Released: July 24, 2003.)
FSP FIN 46-3.	Application of Paragraph 5 of FASB Interpretation No. 46, <i>Consolidation of Variable Interest Entities</i> , When Variable Interests in Specified Assets of a Variable Interest Entity Are Not Considered Interests in the Entity under Paragraph 12 of Interpretation 46. (Released: July 24, 2003.)

Table I

Listing of Recent Pronouncements (cont'd)

Type of Pronouncement	Title and Date of Issuance
FSP FIN 46-4.	Transition Requirements for Initial Application of FASB Interpretation No. 46, <i>Consolidation of Variable Interest Entities</i> . (Released: July 24, 2003.)
FSP FIN 46-5.	Calculation of Expected Losses under FASB Interpretation No. 46, <i>Consolidation of Variable Interest Entities</i> . (Released: July 24, 2003.)
FSP FIN 46-6.	Effective Date of FASB Interpretation No. 46, <i>Consolidation of Variable Interest Entities</i> . (Released: October 9, 2003.)
FSP FIN 46-7.	Exclusion of Certain Decision Maker Fees from Paragraph 8(c) of FASB Interpretation No. 46, <i>Consolidation of Variable Interest Entities</i> . (Released: November 26, 2003.)
FSP FIN 46-8.	Evaluating Whether as a Group the Holders of the Equity Investment at Risk Lack the Direct or Indirect Ability to Make Decisions about an Entity's Activities through Voting Rights or Similar Rights under FASB Interpretation No. 46, <i>Consolidation of Variable Interest Entities</i> . (Released: December 18, 2003.)
FSP FIN 46(R)-1.	Reporting Variable Interests in Specified Assets of Variable Interest Entities as Separate Variable Interest Entities under Paragraph 13 of FASB Interpretation No. 46 (revised December 2003), <i>Consolidation of Variable Interest Entities</i> . (Released: February 12, 2004)
FSP FIN 46(R)-2.	Calculation of Expected Losses under FASB Interpretation No. 46 (revised December 2003), <i>Consolidation of Variable Interest Entities</i> . (Released: February 12, 2004)
FSP FIN 46(R)-3.	Evaluating Whether as a Group the Holders of the Equity Investment at Risk Lack the Direct or Indirect Ability to Make Decisions about an Entity's Activities through Voting Rights or Similar Rights under FASB Interpretation No. 46 (revised December 2003), <i>Consolidation of Variable Interest Entities</i> . (Released: February 12, 2004.)
FSPs Related to Other Accounting Pronouncements	
FSP FIN 45-1.	Accounting for Intellectual Property Infringement Indemnifications under FASB Interpretation No. 45, <i>Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others</i> . (Released: June 11, 2003.)
FSP FIN 45-2.	Whether FASB Interpretation No. 45, <i>Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others</i> , Provides Support for Subsequently Accounting for a Guarantor's Liability at Fair Value. (Released: December 10, 2003.)
FSP FAS 140-1.	Accounting for Accrued Interest Receivable Related to Securitized and Sold Receivables under FASB Statement No. 140, <i>Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities</i> . (Released: April 14, 2003.)

Listing of Recent Pronouncements (cont'd)

Type of Pronouncement	Title and Date of Issuance
FSP FAS 144-1.	Determination of Cost Basis for Foreclosed Assets under FASB Statement No. 15, <i>Accounting by Debtors and Creditors for Troubled Debt Restructurings</i> , and the Measurement of Cumulative Losses Previously Recognized under Paragraph 37 of FASB Statement No. 144, <i>Accounting for the Impairment or Disposal of Long-Lived Assets</i> . (Released: November 11, 2003.)
FSP FAS 146-1.	Determining Whether a One-Time Termination Benefit Offered in Connection with an Exit or Disposal Activity Is, in Substance, an Enhancement to an Ongoing Benefit Arrangement. (Released: September 3, 2003.)
FSP FAS 150-1.	Issuer's Accounting for Freestanding Financial Instruments Composed of More Than One Option or Forward Contract Embodying Obligations under FASB Statement No. 150 (FAS 150), <i>Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity</i> . (Released: October 16, 2003.)
FSP FAS 150-2.	Accounting for Mandatorily Redeemable Shares Requiring Redemption by Payment of an Amount That Differs from the Book Value of Those Shares under FASB Statement No. 150, <i>Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity</i> . (Released: October 16, 2003.)
FSP FAS 150-3.	Effective Date, Disclosures and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150 (FAS 150), <i>Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity</i> . (Released: November 7, 2003.)
FSP FAS 150-4.	Issuers' Accounting for Employee Stock Ownership Plans under FASB Statement No. 150, <i>Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity</i> . (Released: November 7, 2003.)
EITF Issues and Topics	
EITF Issue No. 00-21.	"Revenue Arrangements with Multiple Deliverables." (Consensus reached: November 21, 2002. Scope finalized: May 15, 2003. Effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003.)
EITF Issue No. 01-8.	"Determining Whether an Arrangement Contains a Lease." (Consensus reached: May 15, 2003. Ratified: May 28, 2003.)
EITF Issue No. 02-03.	"Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities." (Consensuses reached: June 19-20, 2002 and October 25, 2002. Clarified: November 21, 2002.)
EITF Issue No. 02-09.	"Accounting for Changes That Result in a Transferor Regaining Control of Financial Assets Sold." (Consensus reached: March 20-21, 2003. Ratified: April 2, 2003.)

Table I

Listing of Recent Pronouncements (cont'd)

Type of Pronouncement	Title and Date of Issuance
EITF Issue No. 02-16.	"Accounting by a Customer (including a Reseller) for Certain Consideration Received from a Vendor." (Consensus reached: November 21, 2002. Modified: January 23, 2003 and March 23, 2003.)
EITF Issue No. 02-18.	"Accounting for Subsequent Investments in an Investee after Suspension of Equity Method Loss Recognition." (Consensus reached: January 23, 2003. Ratified: February 5, 2003.)
EITF Issue No. 03-01.	"The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments." (Consensus reached: November 12-13, 2003. Ratified: November 25, 2003.)
EITF Issue No. 03-02.	"Accounting for the Transfer to the Japanese Government of the Substitutional Portion of Employee Pension Fund Liabilities." (Consensus reached: January 23, 2003. Ratified: February 5, 2003.)
EITF Issue No. 03-03.	"Applicability of EITF Abstracts, Topic No. D-79, "Accounting for Retroactive Insurance Contracts Purchased by Entities Other Than Insurance Enterprises," to Claims-Made Insurance Policies by the Insured Entity." (Consensus reached: May 15, 2003. Ratified: May 28, 2003.)
EITF Issue No. 03-04.	"Determining the Classification and Benefit Attribution Method for a 'Cash Balance' Pension Plan." (Consensus reached: May 15, 2003. Ratified: May 28, 2003.)
EITF Issue No. 03-05.	"Applicability of AICPA Statement of Position 97-2, Software Revenue Recognition, to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software." (Consensus reached: July 31, 2003. Ratified: August 13, 2003.)
EITF Issue No. 03-07.	"Accounting for the Settlement of the Equity-Settled Portion of a Convertible Debt Instrument That Permits or Requires the Conversion Spread to Be Settled in Stock (Instrument C of Issue 90-19)." (Consensus reached: July 31, 2003. Ratified: August 13, 2003.)
EITF Issue No. 03-10.	"Application of EITF Issue No. 02-16 (Issue 02-16), <i>Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor</i> , by Resellers to Sales Incentives Offered to Consumers by Manufacturers." (Consensus reached: November 12-13, 2003. Ratified: November 25, 2003.)
EITF Issue No. 03-11.	"Reporting Realized Gains and Losses on Derivative Instruments That Are Subject to FASB Statement No. 133 (FAS 133), <i>Accounting for Derivative Instruments and Hedging Activities</i> , and Not Held for Trading Purposes as Defined in EITF Issue No. 02-3, <i>Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities</i> ." (Consensus reached: July 31, 2003. Ratified: August 13, 2003.)

Listing of Recent Pronouncements (cont'd)

Type of Pronouncement	Title and Date of Issuance
EITF Issue No. 03-12.	"Impact of FASB Interpretation No. 45 (FIN 45), <i>Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others</i> , on EITF Issue No. 95-1, <i>Revenue Recognition on Sales with a Guaranteed Minimum Resale Value</i> ." (Consensus reached: November 12-13, 2003. Ratified: November 25, 2003.)
Announcements made at EITF Meetings	
EITF Topic No. D-1.	"Implications and Interpretations of an EITF Consensus." (Announcements made: November 21, 2002, January 23, 2003, and May 15, 2003.)
EITF Topic No. D-42.	SEC Staff Announcement. "Clarification of EITF Abstracts, Topic No. D-42, 'The Effect on the Calculation of Earnings per Share for the Redemption or Induced Conversion of Preferred Stock'." (Announcement made: July 31, 2003.)
EITF Topic No. D-98.	SEC Staff Announcement. "Classification and Measurement of Redeemable Securities." (Announcement made: July 31, 2003.)
EITF Topic No. D-107.	SEC Staff Announcement. "Lessor Consideration of Third-Party Residual Value Guarantees." (Announcement made: May 15, 2003.)
AICPA Statements of Position	
SOP 02-2.	Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations, and Clarification of the Performance Indicator. (Issued: December 27, 2002.)
SOP 03-1.	Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts. (Issued: July 7, 2003.)
SOP 03-3.	Accounting for Loans or Certain Debt Securities Acquired in a Transfer. (Issued: December 12, 2003.)
SOP 03-4.	Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the AAG <i>Audits of Investment Companies</i> and SOP 95-2, <i>Financial Reporting by Nonpublic Investment Partnerships</i> . (Issued: December 2003.)
SOP 03-5.	Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide <i>Audits of Investment Companies</i> . (Issued: December 2003.)

Table I

Listing of Recent Pronouncements (cont'd)

Type of Pronouncement	Title and Date of Issuance
GASB Statements and Technical Bulletins	
Statement No. 34.	Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments. (Issued: June 1999.)
Statement No. 36.	Recipient Reporting for Certain Shared Non-Exchange Revenues. (Issued: April 2000.)
Statement No. 37.	Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus. (Issued: June 2001.)
Statement No. 38.	Certain Financial Statement Note Disclosures. (Issued: June 2001.)
Statement No. 39.	Determining Whether Certain Organizations Are Component Units. (Issued: May 2002.)
Statement No. 40.	Deposit and Investment Risk Disclosures, an amendment of GASB Statement No. 3. (Issued: March 2003.)
Statement No. 41.	Budgetary Comparison Schedules—Perspective Differences, an amendment of GASB Statement No. 34. (Issued: May 2003.)
Statement No. 42.	Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries. (Issued: November 2003.)
Technical Bulletin No. 2003-1.	Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets. (Issued: June 2003.)
FASB Exposure Drafts	
	Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3. (Issued: December 15, 2003. Comment period ends April 13, 2004.)
	Exchanges of Productive Assets—an amendment of APB Opinion No. 29. (Issued: December 15, 2003. Comment period ends April 13, 2004.)
	Earnings per Share—an amendment of FASB Statement No. 128. (Issued: December 15, 2003. Comment period ends April 13, 2004.)
	Inventory Costs—an amendment of ARB No. 43, Chapter 4. (Issued: December 15, 2003. Comment period ends April 13, 2004.)
	Qualifying Special-Purpose Entities and Isolation of Transferred Assets—an amendment of FASB Statement No. 140. (Issued: June 10, 2003. Comment period ended July 31, 2003.)
	Accounting for Real Estate Time-Sharing Transactions—an amendment of FASB Statements No. 66 and 67. (Issued concurrently with Proposed AICPA Statement of Position, <i>Accounting for Real Estate Time-Sharing Transactions</i> : February 20, 2003.)

Listing of Recent Pronouncements (cont'd)

Type of Pronouncement	Title and Date of Issuance
	Accounting in Interim and Annual Financial Statements for Certain Costs and Activities Related to Property, Plant, and Equipment—an Amendment of APB Opinions No. 20 and 28 and FASB Statements No. 51 and 67 and a Rescission of FASB Statement No. 73. (Issued concurrently with Proposed AICPA Statement of Position, <i>Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment</i> : June 29, 2001.)
AICPA Exposure Drafts	
Proposed SOP.	Accounting by Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements Other Than Those Specifically Described in FASB Statement No. 97. (Issued: March 2003. Comment period ended May 14, 2003.)
Proposed SOP.	Accounting for Real Estate Time-Sharing Transactions. (Issued: February 2003. Comment period ended April 30, 2003.)
Proposed SOP.	Clarification of the Scope of the Audit and Accounting Guide. <i>Audits of Investment Companies</i> and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies. (Issued: December 2002. Comment period ended March 31, 2003.)
Proposed SOP.	Allowance for Credit Losses. (Issued: June 2003. Comment period ended September 19, 2003.)
Proposed SOP.	Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment. (Issued: June 2001. Comment period ended: October 15, 2001.)
GASB Exposure Drafts	
	Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions. (Issued: February 14, 2003. Comment period ended: April 30, 2003. Revised Exposure Draft issued: January 30, 2004. Comment period ends: April 30, 2004.)
	Financial Reporting for Postemployment Benefit Plans Other than Pension Plans. (Issued: February 14, 2003. Comment period ended: April 30, 2003.)
	Plain-Language Supplement, Other Postemployment Benefits. (Issued: February 14, 2003. Comment period ended: April 30, 2003.)
	Tobacco Settlement Recognition and Financial Reporting Entity Issues. (Proposed Technical Bulletin issued: December 31, 2003. Comment period ended March 2, 2004.)
	Economic Condition Reporting: The Statistical Section—an amendment of NCGA Statement 1. (Issued: August 29, 2003. Comment period ended November 28, 2003.)

Summary of Effective Dates

Table 2

Pronouncements	Effective Dates and Transition
<p>FASB Statement No. 132 (Revised 2003), <i>Employers' Disclosures about Pensions and Other Postretirement Benefits</i></p>	<p><i>General effective dates:</i> New or revised disclosure requirements are effective according to the following schedule:</p> <ul style="list-style-type: none"> • Annual disclosures: fiscal years ending after December 15, 2003. • Interim period disclosures: interim periods beginning after December 15, 2003. <p><i>Exceptions:</i> (a) Disclosure of information about foreign plans is effective for fiscal years ending after June 15, 2004. (b) Disclosure about future benefit payments is effective for fiscal years ending after June 15, 2004. (c) Disclosure of information for nonpublic entities is effective for fiscal years ending after June 15, 2004. Special disclosure requirements apply when the financial statements exclude information about foreign plans during the transition period.</p> <p><i>Rules for restatements:</i> Disclosures for earlier annual periods presented for comparative purposes must be restated for (a) the percentages of each major category of plan assets held, (b) the accumulated benefit obligation, and (c) the assumptions used in the accounting for the plans. The disclosures for earlier interim periods presented for comparative purposes must be restated for the components of net benefit cost.</p> <p><i>Exceptions:</i> If obtaining the information relating to earlier periods is not practicable, the notes to the financial statements shall include all available information and identify the information not available.</p> <p>Early application: Encouraged.</p>
<p>FASB Statement No. 146, <i>Accounting for Costs Associated with Exit or Disposal Activities</i></p>	<p><i>General effective date:</i> Applies on a prospective basis for exit or disposal activities initiated after December 31, 2002.</p> <p><i>Rules for restatements:</i> Companies should not restate previously issued financial statements. Instead, they should continue to apply the provisions of EITF issue No. 94-3, including its disclosure requirements, for an exit activity initiated under an exit plan that met the conditions of EITF Issue No. 94-3 prior to the effective date of Statement 146.</p>
<p>FASB Statement No. 147, <i>Acquisitions of Certain Financial Institutions</i></p>	<p>Applies to acquisitions for which the date of acquisition is on or after October 1, 2002. Applies to long-term customer-relationship intangible assets effective October 1, 2002. The transition provisions for previously recognized unidentifiable intangible assets are effective on October 1, 2002.</p>
<p>FASB Statement No. 148, <i>Accounting for Stock-Based Compensation -Transition and Disclosure</i></p>	<p>Applies to annual and interim financial statements for years ending after December 15, 2002.</p>

Summary of Effective Dates (cont'd)

Table 2

Pronouncements	Effective Dates and Transition
<p>FASB Statement No. 149, <i>Amendment of Statement 133 on Derivative Instruments and Hedging Activities</i></p>	<p><i>General effective date:</i> Applies prospectively to contracts entered into or modified after June 30, 2003 and hedging relationships designated after June 30, 2003.</p> <p><i>Exceptions:</i> (a) The amendments to Statement 133 that resulted principally from the Derivatives Implementation Group Process and have been cleared by the FASB and effective for fiscal quarters that began prior to June 15, 2003 should continue to be applied in accordance with their respective effective dates. (b) The revised guidance included in the implementation issues that were modified in accordance with the decisions made as part of the amendment process applies prospectively to contracts entered into after June 30, 2003. (c) The guidance relating to forward purchases or sales of when-issued or other securities that do not yet exist applies to both existing contracts and new contracts entered into after June 30, 2003.</p>
<p>FASB Statement No. 150, <i>Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity</i></p>	<p><i>Original effective date:</i> As originally issued, Statement 150 was effective for mandatorily redeemable shares of private companies for fiscal periods beginning after December 15, 2003. For all other instruments in the scope of Statement 150, the effective dates were as follows:</p> <ul style="list-style-type: none"> • Immediately, for instruments entered into or modified after May 31, 2003. • The first interim period beginning after June 15, 2003 for preexisting instruments. <p><i>Revised effective dates:</i> As a result of the partial deferrals made by FSPs, the effective dates for the standard are now as follows:</p> <ul style="list-style-type: none"> • Private companies must apply the standard no later than fiscal periods beginning after December 15, 2004 to instruments that are mandatorily redeemable on fixed dates for amounts that are fixed or determinable. The requirements were deferred indefinitely for other mandatorily redeemable shares issued by private companies. • For public companies, the classification and measurement provisions are deferred indefinitely (and early adoption is precluded) for noncontrolling interests in consolidated financial statements, if these interests are deemed mandatorily redeemable only because the issuing entity has a limited life. A more limited deferral applies to certain other types of mandatorily redeemable noncontrolling interests created before November 5, 2003. <p>There was no change in the effective dates for other types of instruments.</p>

Summary of Effective Dates (cont'd)

Table 2

Pronouncements	Effective Dates and Transition
<p>FASB Interpretation No. 45, <i>Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others</i></p>	<p><i>General effective date:</i> Guarantors should apply the initial recognition and measurement provisions of Interpretation 45 on a prospective basis to guarantees issued or modified after December 31, 2002, regardless of the guarantor's year-end. The disclosure requirements are effective for financial statements of both interim and annual periods ending after December 15, 2002.</p> <p><i>Rule for restatements:</i> The guarantor's previous accounting for guarantees issued before December 31, 2002 should not be revised or restated.</p>
<p>FASB Interpretation No. 46, <i>Consolidation of Variable Interest Entities</i></p>	<p><i>Original effective dates:</i> Applies immediately to variable interest entities created after January 31, 2003. For variable interest entities in which a company obtained an interest before that date, it applies in the first fiscal year or interim period beginning after June 15, 2003. The Interpretation applies to public companies as of the beginning of the applicable interim or annual period, and it applies to nonpublic companies as of the end of the applicable annual period.</p> <p><i>Revised effective date:</i> FASB Staff Position FSP FIN 46-6 modified the effective date of Interpretation 46 for public companies with VIEs meeting certain conditions. The revised effective date was the end of the first interim or annual period ending after December 15, 2003.</p> <p><i>Status:</i> Interpretation 46 was replaced by 46R in December 2003. But some companies may continue to apply its provisions during a transition period. Interpretation 46R revised the scope of the Interpretation to exclude some entities. Companies with non-excluded VIEs will need to study Interpretation 46R to see whether it affects their computations.</p> <p><i>Rule for restatements:</i> Interpretation 46 called for application prospectively with a cumulative-effect adjustment as of the date on which it was first applied or by restating previously issued financial statements for one or more years with a cumulative-effect adjustment as of the beginning of the first year restated.</p>
<p>FASB Interpretation No. 46 (Revised 2003), <i>Consolidation of Variable Interest Entities (Revised 2003)</i></p>	<p><i>General effective dates:</i></p> <ul style="list-style-type: none"> Public companies must apply either Interpretation 46 or Interpretation 46R to all Special Purpose Entities created prior to February 1, 2003 at the end of the first interim or annual reporting period ending after December 15, 2003. All entities created after January 31, 2003 must be evaluated for possible consolidation under Interpretation 46 unless FIN 46R is adopted early. For non-SPE VIEs that pre-date Interpretation 46 (that is, were created prior to January 31, 2003), public companies are required to adopt Interpretation 46R no later than the end of the first interim or annual reporting period ending after March 15, 2004 (December 15, 2004 for small business filers).

(continued on next page)

Summary of Effective Dates (cont'd)

Table 2

Pronouncements	Effective Dates and Transition
FASB Interpretation No. 46 (Revised 2003) , <i>Consolidation of Variable Interest Entities</i> (Revised 2003) (continued)	<ul style="list-style-type: none"> Private companies are required to apply Interpretation 46R immediately to VIEs created after December 31, 2003 and by the beginning of the first reporting period beginning after December 15, 2004 for entities created prior to December 31, 2003.
SOP 02-2 , <i>Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations, and Clarification of the Performance Indicator</i>	Applies on a prospective basis for fiscal years beginning after June 15, 2003. Earlier application of SOP 02-2 is encouraged, but is permitted only as of the beginning of any fiscal quarter that begins after its issuance. A not-for-profit health care organization that previously reported derivative gains or losses in financial statements issued prior to adoption of the SOP that were inconsistent with the conclusions of SOP 02-2 is not permitted to reclassify those gains or losses upon adoption.
SOP 03-1 , <i>Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts</i>	The provisions of this SOP are effective for financial statements for fiscal years beginning after December 15, 2003, with earlier adoption encouraged. Initial application of this SOP should be as of the beginning of an entity's fiscal year (that is, if the SOP is adopted prior to the effective date and during an interim period, all prior interim periods should be restated). Disclosures of the pro forma effects of retroactive application or the pro forma effect on the year of adoption are not required. Restatement of previously issued annual financial statements or reclassification between separate account and general account balances is not permitted.
SOP 03-3 , <i>Accounting for Loans or Certain Debt Securities Acquired in a Transfer</i>	This SOP is effective for loans acquired in fiscal years beginning after December 15, 2004. Previously issued annual financial statements should not be restated. Early application of this SOP is encouraged, but not required, for transfers of loans subsequent to the issuance of this SOP but prior to the effective date.
SOP 03-4 , <i>Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the AAG Audits Of Investment Companies and SOP 95-2, Financial Reporting by Nonpublic Investment Partnerships</i>	The provisions of this SOP, except for the provisions to require certain non-registered investment partnerships to compute and disclose the internal rate of return from inception (IRR), are effective for annual financial statements issued for fiscal years ending after December 15, 2003, and for interim financial statements issued after initial application. The provisions to require certain nonregistered investment partnerships to compute and disclose IRR are effective for annual financial statements issued for fiscal years beginning after December 15, 2003, with early application encouraged. Nonregistered investment partnerships that do not early adopt the disclosure of IRR should disclose a total rate of return. Presentation of previously issued financial highlights is not required; however, if comparative financial highlights are presented, the presentation should be on a comparable basis.

Summary of Effective Dates (cont'd)

Table 2

Pronouncements	Effective Dates and Transition
SOP 03-5 , <i>Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide Audits of Investment Companies</i>	The provisions of this SOP are effective for annual financial statements issued for fiscal years ending after December 15, 2003, and for interim financial statements issued after initial application. Presentation of previously issued financial highlights on a comparable basis is permitted, but not required. The provisions of this SOP should be applied prospectively from the beginning of the year of adoption. However, if adopting this SOP results in presentation different from prior periods, companies should explain the effects of adoption on their financial highlight calculations.
GASB Statement No. 34 , <i>Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments</i>	The effective dates vary according to the revenues of the governmental entity. Revenue brackets and effective dates are as follows: <ul style="list-style-type: none"> • For governments with defined revenues exceeding \$100 million, the Statement is effective for fiscal years beginning after June 15, 2001. • For governments with defined revenues exceeding \$10 million but less than \$100 million, the Statement is effective for fiscal years beginning after June 15, 2002, • For governments with defined revenues less than \$10 million, the Statement is effective for fiscal years beginning after June 15, 2003. <p>Early adoption is permitted.</p>
GASB Statement No. 36 , <i>Recipient Reporting for Certain Shared Non-Exchange Revenues</i>	Applies to fiscal years beginning after June 15, 2000. The accrual revenue provisions are effective upon adoption of GASB Statement 34.
GASB Statement No. 37 , <i>Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus</i>	This Statement should be simultaneously implemented with GASB Statement 34. For governments that implemented GASB Statement 34 prior to the issuance of GASB Management's Discussion and Analysis - Statement 37, its requirements are effective for financial statements for periods beginning after June 15, 2000
GASB Statement No. 38 , <i>Certain Financial Statement Note Disclosures</i>	Generally applies when the entity is required to implement the provisions of GASB Statement 34, except the requirements related to short-term debt, receivable and payable balances, interfund balances, and interfund transfers may be implemented one year later by certain governments. Earlier application is encouraged.
GASB Statement No. 39 , <i>Determining Whether Certain Organizations Are Component Units</i>	Applies to financial statements for periods beginning after June 15, 2003. Adjustments resulting from a change to comply with this Statement should be treated as adjustments of prior periods. The financial statements of all prior periods presented should be restated, if practical, to show the financial information of the new reporting entity for all periods. If restatement of the financial statements for prior periods is not practical, the cumulative effect of applying this Statement should be reported as a restatement of beginning net assets/fund balance for the earliest period restated. In the period this Statement is first applied, the financial statements should disclose the nature of the restatement and its effect.

Summary of Effective Dates (cont'd)

Table 2

Pronouncements	Effective Dates and Transition
<p>GASB Statement No. 40, <i>Deposit and Investment Risk Disclosures, an amendment of GASB Statement No. 3</i></p>	<p>The requirements of this Statement are effective for financial statements for periods beginning after June 15, 2004. Earlier application is encouraged.</p>
<p>GASB Statement No. 41, <i>Budgetary Comparison Schedules—Perspective Differences, an amendment of GASB Statement No. 34</i></p>	<p>This Statement should be implemented simultaneously with Statement 34. For governments that have implemented Statement 34 prior to the issuance of this Statement, the requirements of this Statement are effective for financial statements for periods beginning after June 15, 2002.</p>
<p>GASB Statement No. 42, <i>Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries</i></p>	<p>Effective for financial statements for periods beginning after December 15, 2004. Earlier adoption is encouraged. Accounting changes adopted to conform to the provisions of this Statement should be applied retroactively by restating financial statements, if practical, for all prior periods presented. If restatement is not practical, the cumulative effect of applying this Statement, if any, should be reported as a restatement of beginning net assets, fund balances, or fund equity, as appropriate, for the earliest period restated. In the period this Statement is first applied, the financial statements should disclose the nature of any restatement and its effect. Also the reason for not restating prior periods presented should be explained. Previously reported impairments, if any, resulted in a new cost basis for the impaired capital asset and should not be restated.</p>
<p>GASB Technical Bulletin No. 2003-1, <i>Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets</i></p>	<p>Effective for financial statements for periods ending after June 15, 2003. Earlier adoption is encouraged.</p>

Material discussed in this *Financial Reporting* newsletter is meant to provide general information and should not be acted upon without first obtaining professional advice appropriately tailored to your individual facts and circumstances.