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Contents:

Commission Rulemaking.....	3
Audit Committee Financial Expert Disclosures.....	3
Standards for Listed Company Audit Committees.....	3
Auditor Independence Requirements.....	4
Internal Control Reporting	6
Improper Influence on Conduct of Audits	7
Audit Records Retention Requirements.....	7
Code of Ethics Disclosures	8
Standards of Conduct for Attorneys.....	8
MD&A Disclosure – Off-Balance Sheet Arrangements and Contractual Obligations.....	8
Use of Non-GAAP Financial Measures.....	9
Insider Trades During Pension Fund Blackout Periods.....	10
Electronic Filing and Website Posting of Forms 3, 4 and 5	10
Equity Securities Purchases by the Issuer	10
Director Nomination and Shareholder Communication Processes	11
Commission and Staff Guidance	11
Results of Fortune 500 Company Report Reviews.....	11
MD&A Interpretive Guidance	11
SAB Codification Update	11
SAB 104	12
For Further Information.....	12

SEC Year in Review

Significant 2003 Developments

In 2003, the Securities and Exchange Commission completed what was probably the busiest period of rulemaking in its history. The Sarbanes-Oxley Act of 2002 (the Act) required the SEC to adopt rules to implement a number of its provisions. In many cases, the time Congress allotted for adopting these rules was short, so implementing the Act dominated the SEC's rulemaking agenda in late 2002 and the first half of 2003. However, as the year progressed, the Commission began addressing a number of other important matters, particularly in the areas of improving corporate governance and mutual fund industry reform. The rules the Commission adopted are significant, and implementing them (while at the same time meeting the accelerated reporting deadlines that begin to affect many issuers this reporting season) will surely present significant challenges for issuers and their auditors.

This letter focuses on rules the Commission adopted in 2003 that are aimed at restoring confidence in the financial reporting process and providing more fairness and openness in the activities of those who govern issuers of securities.

The SEC adopted several rules designed to strengthen the financial reporting and auditing processes:

- New SEC and exchange rules are aimed at strengthening the composition of audit committees and their role in the audit process. Companies must

now disclose whether their audit committees include an independent financial expert. New listing standards will require audit committee members to be independent and require audit committees to be directly responsible for the appointment, compensation, retention, and oversight of the work of a company's auditors.

- New auditor independence requirements enhance audit committees' ability to fulfill their role and change the relationship between auditors and the companies they audit.
- In what many believe is the most significant of all the rule-making driven by the Act, management will be required to report annually on the effectiveness of their company's internal controls, and auditors will be required to conduct and report on the results of an audit of those controls.
- Rules prohibiting improper influence on the conduct of audits were adopted to ensure that management makes open and full disclosures to and has honest discussions with the company's auditors.
- Other rules were adopted to ensure that auditors retain records that may be relevant to investigations of financial reporting improprieties or audit deficiencies. These rules require accounting firms to retain records relevant to their audits and reviews for seven years.

The SEC also adopted rules aimed at restoring confidence in the behavior of corporate officers and attorneys:

- A company must now disclose whether it has adopted a code of ethics for its principal executive and senior financial officers and, if not, the reasons why not, as well as any changes to or waivers of that code.

- New standards of conduct require attorneys to act when they become aware of actual or potential material violations of laws or breaches of fiduciary duty.

Other rule changes address weaknesses in reporting and disclosure practices:

- A company must now provide a comprehensive explanation of its off-balance sheet arrangements and an overview of its aggregate contractual obligations.
- Other new rules address abuses related to presenting "pro forma," or "non-GAAP," financial measures.

Still other rule changes are designed to provide more fairness and openness in the activities of those who govern issuers of securities:

- New Regulation BTR prohibits directors and executive officers from trading company equity securities during a blackout period.
- Insider reports of ownership changes must now be filed electronically, and issuers with websites must make them available on or through their websites.
- In 2004 periodic reports, issuers will be required to provide disclosures about purchases of their equity securities.
- Beginning with the 2004 proxy season, issuers must provide a number of detailed disclosures regarding the company's process for nominating directors and the process by which shareholders can communicate with the board.

This letter also focuses on interpretive guidance the Commission and its staff provided during 2003. The Commission provided important interpretive guidance regarding preparing Management's Discussion and Analysis (MD&A). The Commission's staff provided a helpful report that discusses common issues it noted in its reviews

of the filings of the Fortune 500 companies and updated its Staff Accounting Bulletins.

Although not the focus of this letter, it should also be noted that in 2003 the Commission began overseeing the activities of the Public Company Accounting Oversight Board, the new regulator of auditors of public companies. In April, the SEC determined that the PCAOB was appropriately organized and had the capacity to carry out its duties under the Act. Subsequently, the SEC approved PCAOB rules covering registration of accounting firms that audit public companies. These rules required domestic firms to register with the PCAOB in 2003 and will require foreign firms to register in 2004. In addition, the SEC approved a PCAOB rule that requires all registered public accounting firms to adhere to the PCAOB's auditing and related professional practice standards. (While this requirement is implicit in the Act, this PCAOB rule codified that obligation.) The Commission has also approved PCAOB rules covering its by-laws, funding, code of ethics, and procedures for forming advisory groups to assist it in developing new standards.

Looking forward to 2004, the Commission can be expected to continue to focus on mutual fund industry reform as well as controversial proposals that would require attorneys to report misconduct outside a company and change the director election process by requiring the issuers to include in their proxy materials the names of candidates nominated by shareholders. Senior members of the Commission's staff have stated that the Commission may take action to reform the process by which securities are offered and sold under the Securities Act (although on a much less ambitious scale than the "aircraft carrier" proposal made in 1998). The Commission also has rulemaking

proposals outstanding that would prescribe disclosure requirements for critical accounting estimates and provide more and faster current events reporting by increasing the number of events to be reported on Form 8-K and accelerating the filing deadlines.

This letter summarizes the 2003 Commission and staff activities described above. The Commission publishes rulemaking releases that provide background and the text of its rule changes. They are available on its website (www.sec.gov) under *Regulatory Actions – Final Rule Releases*. The Commission and staff guidance summarized in this letter is also available on the SEC's website. The locations are provided below in the sections in which the guidance is discussed.

We previously covered many of the topics summarized in this letter in the following BDO Seidman *Financial Reporting* letters:

- SEC Meets Sarbanes-Oxley Act Rulemaking Deadline – March 2003
- SEC Completes Mandated Sarbanes-Oxley Act Rulemaking – July 2003
- SEC Insights – February 2004

These letters discuss those topics in greater detail and are available on our website (www.bdo.com/about/publications/assurance/). References to applicable letters are provided below. Also available on our website is our Sarbanes-Oxley Act *Implementation Reference Guide*, which outlines the key SEC rulemaking to implement the Act and provides observations regarding interpreting and implementing those rules.

Commission Rulemaking

Audit Committee Financial Expert Disclosures (Release 33-8177)

In January, the SEC adopted rules that require a company to disclose

in its annual report whether or not it has at least one audit committee financial expert serving on its audit committee. If so, it must disclose the name of that person and whether that person is independent. If the company does not have an audit committee financial expert, it must explain why.

These new disclosure requirements apply to all issuers, including small business issuers and foreign private issuers, other than registered investment companies. (In a separate release, the SEC adopted similar rules for investment companies.)

To qualify as an audit committee financial expert, a person must have an understanding of GAAP, financial statements, internal controls, and audit committee functions. The person must also be able to assess the application of GAAP and have experience with the financial reporting process.

These disclosures are required in annual reports for fiscal years ended on or after July 15, 2003 for large issuers and for fiscal years ended on or after December 15, 2003 for small business issuers.

See our March 2003 *Financial Reporting* letter for further details.

Standards for Listed Company Audit Committees (Release 33-8220)

In April, the Commission adopted new Exchange Act Rule 10A-3, which prohibits the national securities exchanges and associations from listing the securities of an issuer that is not in compliance with the Act's standards for audit committees. This new rule and amendments to existing rules also affect listed issuers directly by requiring them to make certain disclosures.

The rules affect issuers whose securities are listed on a national securities exchange or association (e.g., the NYSE, AMEX, and

Nasdaq). Issuers whose securities are quoted on interdealer quotation systems, such as the OTC Bulletin Board, the Pink Sheets, and the Yellow Sheets, are not affected. The rules apply to both domestic issuers (including small business issuers) and foreign issuers. They also apply to investment companies, although they have been tailored to reflect certain unique aspects of investment companies' organizational structures and safeguards already provided by the Investment Company Act.

Rule 10A-3 requires an issuer's audit committee to meet five standards for the issuer's securities to be listed:

1. *Independence* – Each member of the audit committee must meet independence standards related to compensation and affiliate status. The compensation standards prohibit a member from receiving, either directly or indirectly, any compensation from the company other than in his or her capacity as a member of the board and its committees.
A member also must not be an affiliate of the issuer or any of its subsidiaries. Executive officers, directors who are also employees of an affiliate, general partners, and managing members of an affiliate are deemed to be affiliates.
2. *Responsibilities Relating to Registered Public Accounting Firms* – The audit committee must be directly responsible for the appointment, compensation, retention, and oversight of the work of auditors who provide audit services to the issuer (whether the services are provided by the principal auditor or another firm).
3. *Procedures for Handling Complaints* – The audit committee must establish procedures for the receipt, retention, and treat-

ment of complaints regarding accounting, internal accounting controls, or auditing matters, including procedures for the confidential anonymous submission by employees of concerns regarding questionable accounting or auditing matters.

4. *Authority to Engage Advisors* – The audit committee must have the authority to engage independent counsel and other advisors as it determines necessary to carry out its duties.

5. *Funding* – The issuer must provide appropriate funding for the audit committee to compensate the outside auditors and any lawyers and advisors it employs and to fund ordinary administrative expenses of the audit committee that are necessary in carrying out its duties.

Rule 10A-3 contains a number of exemptions and exceptions, including exceptions to the independence rules for foreign private issuers to accommodate the different legal requirements of some foreign jurisdictions.

Other new rules require certain disclosures. Issuers must include in their annual reports the names of each audit committee member. If an issuer does not have a separate audit committee, it must state that the entire board of directors is acting as the audit committee. In addition, an issuer that relies on certain of the exemptions or exceptions must disclose this fact in its annual report and its proxy materials covering elections of directors. The disclosure must include the issuer's assessment of whether, and if so, how, such reliance would materially adversely affect the ability of the audit committee to act independently and to satisfy the other requirements of Rule 10A-3.

Issuers other than foreign private issuers and small business issuers must comply with the new listing requirements by the earlier of

(i) their first annual shareholders meeting after January 15, 2004, or (ii) October 31, 2004. Foreign private issuers and small business issuers must comply by July 31, 2005.

See our July 2003 *Financial Reporting* letter for further details.

The NYSE, AMEX, and Nasdaq have amended their listing standards to comply with the audit committee requirements in Rule 10A-3. They have also amended their listing standards to enhance corporate governance practices. In some respects, the revised listing standards are more stringent than the requirements of Rule 10A-3. The SEC's order approving the amended NYSE and Nasdaq listing standards can be found on the SEC's website (www.sec.gov/rules/sro/34-48745.htm). The SEC's order approving the amended AMEX listing standards can be found on the AMEX's website (www.amex.com) in the *News and Events – News Releases* section. The NYSE has published a frequently asked questions (FAQ) document covering its rules. This document is available on the NYSE's website (www.nyse.com/pdfs/section303Afaqs.pdf).

Auditor Independence Requirements (Release 33-8183)

In January, the SEC adopted new auditor independence rules that implement Sections 201, 202, 203, 204 and 206 of the Act.

Audit committees play a critical role in the financial reporting process and in helping accountants maintain their independence from audit clients. The new rules are intended to enhance audit committees' ability to fulfill that role by giving them responsibility for appointing and compensating auditors and overseeing their work. To that end, the new rules:

- Require audit committees to pre-approve all services provided by auditors and

- Require auditors to communicate certain matters to audit committees.

The rules are also intended to strengthen auditors' independence by changing the relationship between auditors and the companies they audit. They:

- Prohibit auditors from providing certain non-audit services to their publicly held audit clients;
- Require greater audit partner rotation;
- Restrict employment of audit team members by a client; and
- Prohibit accounting firms from compensating audit partners for selling non-audit services to their audit clients.

These changes are quite significant because even minor inadvertent violations generally cause the auditor to lose his or her independence.

The rules also enhance the information companies provide regarding the fees they pay to their auditors and require them to disclose their audit committees' practices for pre-approving services provided by their auditors.

The rules apply to all domestic and foreign registrants, as well as to registered investment companies. They were effective May 6, 2003 but contain certain transition provisions that are discussed below.

Audit Committee Pre-Approval of Services – Audit committees must pre-approve all audit and permitted non-audit services. An auditor will be deemed to be not independent if he or she performs services without pre-approval.

The audit committee can either pre-approve a service (1) directly before the accountant is engaged, or (2) indirectly via policies and procedures it establishes. Pre-approval policies and procedures must be "detailed as to the particular service," the audit committee

must be “informed of each service,” and the policies and procedures must “not include delegation of the audit committee’s responsibilities . . . to management.”

There is a de minimis exception for permitted non-audit services. The pre-approval requirement is waived if the services were not recognized at the time of the engagement to be non-audit services and, once recognized, are promptly brought to the attention of the audit committee and approved prior to the completion of the audit. The aggregate amount of all services approved in this manner may not constitute more than five percent of the total fees paid to the auditor during the fiscal year in which the services are provided.

The pre-approval requirements apply to all contracts for services entered into after May 6, 2003. Services previously arranged are not subject to the pre-approval requirements, as long as they are completed by May 6, 2004.

Auditor Communications with Audit Committees – An auditor must communicate the following matters to the audit committee before the company files the auditor’s report with the SEC:

- All critical accounting policies and practices used by the company;
- All alternative accounting treatments within GAAP related to material items that have been discussed with management; and
- Other material written communications between the accounting firm and management.

These communications must be made prior to the filing of an auditor’s report that is filed on or after May 6, 2003.

Services Outside the Scope of Practice of Auditors – The Commission expanded its list of prohibited services and eliminated certain exceptions provided in the previous

rules. Services that would impair an auditor’s independence if he or she provided them for a publicly held audit client include:

- Bookkeeping services
- Financial information systems design and implementation
- Appraisal or valuation services
- Actuarial services
- Internal audit outsourcing services
- Management functions
- Human resources services
- Broker or dealer, investment advisor, or investment banking services
- Legal services
- Expert services unrelated to the audit

The rules do *not* prohibit an accounting firm from providing tax services to its audit clients when those services have been pre-approved by the audit committee.

These prohibitions were effective as of May 6, 2003. For contracts in existence on May 6, 2003, providing previously permitted non-audit services will not impair an accountant’s independence unless they are still being provided on or after May 6, 2004.

Audit Partner Rotation Requirements – The new rules expand the rotation requirements to all “audit partners,” defined as partners on the audit engagement team who (1) have significant decision-making responsibility on auditing, accounting, and reporting matters, or (2) maintain regular contact with management and the audit committee. The new rules specify that this includes (1) the lead audit partner, (2) the concurring partner, (3) other audit partners who spend more than ten hours performing audit, review, or attest work at the issuer level, and (4) the lead partners on subsidiaries whose assets or revenues constitute 20% or more of consolidated assets or revenues. The definition specifically excludes partners who provide consultation

on technical or industry-specific issues, transactions, or events (e.g., partners assigned to national office duties, including technical accounting and centralized quality control functions). There is also an exemption for small firms.

The permitted service and required time-out periods for the partners subject to rotation are:

- The lead partner and concurring partner are required to rotate off the audit after five consecutive years of service in either role. They must then complete a five-year time-out period before they can resume providing services in either of these roles.
 - All other audit partners subject to rotation are required to rotate off the audit after seven consecutive years of service. They must then complete a two-year time-out period before they can resume providing services to the client.
- The transition provisions for the rotation requirements are as follows:
- The rotation requirements applicable to lead partners are effective for the first fiscal year that began after May 6, 2003. Time served as a lead or concurring partner in prior years is included in determining the five-year service period.
 - The rotation requirements applicable to concurring partners are effective for the first fiscal year that begins after May 6, 2004. Time served as a lead or concurring partner in prior years is included in determining the five-year service period.
 - For lead and concurring partners with foreign accounting firms and all other audit partners, the rules are effective for the first fiscal year that began after May 6, 2003. Time served in prior years does not count toward the maximum service periods.

Employment of Audit Team Members by a Client – A cooling off period is now required before a member of the audit engagement team can be employed by the client in a “financial reporting oversight role.” A “financial reporting oversight role” is one in which a person is in a position to influence the contents of a company’s financial statements and related information (e.g., MD&A) included in its SEC filings. People in such positions include but are not limited to members of the board of directors and executive and financial officers. The cooling off requirement does not apply to members of the audit engagement team (other than the lead and concurring partners) who provided fewer than ten hours of audit, review, or attest services.

The cooling off period requires an accounting firm to complete one annual audit subsequent to the audit in which an individual participated before the issuer can hire the individual in a financial reporting oversight role. There are exceptions for employment that results from a business combination and for individuals employed in emergency or unusual circumstances.

Partner Compensation – The new rules prohibit accounting firms from compensating audit partners for selling non-audit services to their audit clients. Small firms are exempt from these rules.

These rules were effective for the first fiscal year of the accounting firm that began after May 6, 2003.

Disclosures Regarding Fees and Audit Committee Practices – The new rules increase the categories of fees that must be disclosed and the years covered by the disclosure. The categories that must be disclosed are (a) audit fees, (b) audit-related fees, (c) tax fees, and (d) all other fees. The disclosures

must show fees for each of the two most recent years, rather than the previous requirement to disclose information for only the most recent fiscal year. Also, companies must describe the nature of the services provided for all categories except audit fees.

A company must also disclose the audit committee’s policies and procedures for pre-approving services to be provided by the auditor. Alternatively, companies may provide a copy of those policies and procedures. If the audit committee has applied the de minimis exception discussed above, the issuer must disclose the percentage of total fees paid to the accountant, by category, where the de minimis exception was used.

These rules are effective for annual reports for fiscal years ended after December 15, 2003 and related proxy materials.

See our March 2003 *Financial Reporting* letter for further details.

In August, the SEC staff published an FAQ document covering these rules. This document is available on the SEC’s website (http://www.sec.gov/info/accountants/ocaf_aqaudind080703.htm). The FAQ addresses 35 questions covering the following topics:

- Partner rotation
- Non-audit services
- Audit committee pre-approval requirements
- Audit committee communications
- Fees disclosures
- “Cooling off” period
- Broker-dealers and investment advisors

Internal Control Reporting (Release 33-3238)

The Commission adopted new rules that implement Section 404 of the Act in May. These rules require a company’s management to evaluate and report on the effectiveness of its internal control over

financial reporting in each annual report. They also require a company to engage its auditor to conduct and report on the results of an audit of those controls in each annual report.

These requirements apply to all issuers, other than registered investment companies, that report pursuant to Section 13(a) or 15(d) of the Exchange Act (including small business issuers and foreign private issuers). However, the reporting requirements do not apply to benefit plans that file on Form 11-K.

The management of each issuer must evaluate, with the participation of the issuer’s principal executive and financial officers, the effectiveness of the issuer’s internal controls as of the end of each fiscal year. The evaluations must be based on a framework that meets specified criteria. The COSO framework will satisfy the criteria. However, the rules do not mandate the use of a particular framework.

A company must maintain evidential matter, including documentation, to provide reasonable support for management’s conclusions. Inquiry alone will not provide an adequate basis for management’s assessment. The assessment must be based on procedures sufficient to both evaluate the design of the controls and test their operating effectiveness. Non-management personnel may perform this work. However, management must actively supervise the entire process.

Management must report on the company’s internal controls in the annual report. The report must disclose any material weaknesses in the company’s internal controls, and management is not permitted to conclude that the company’s internal controls are effective if there are one or more material weaknesses.

A company must also file its public accounting firm’s report on

its audit of the company's internal controls as part of the annual report. The attestation cannot be the subject of a separate engagement. An issuer's primary auditor must issue the attestation report.

The effective dates for management reporting and auditor attestation are as follows:

- For accelerated filers – annual reports for fiscal years ending on or after June 15, 2004.
- All other issuers, including foreign private issuers and small business issuers – annual reports for fiscal years ending on or after April 15, 2005.

In addition, starting with the first quarter after a company first provides the reports discussed above, management of a domestic issuer must also evaluate whether any change in the issuer's internal controls occurred during each fiscal quarter (including the fourth quarter) that has materially affected, or is reasonably likely to materially affect, the issuer's internal control. Foreign private issuers will need to perform this evaluation on an annual basis. (This requirement should be distinguished from the requirement to report significant changes in internal control over financial reporting on a quarterly basis *if* such changes are identified. The requirement to report such changes has been in effect since 2002.)

The SEC also made changes to the quarterly evaluation and reporting requirements for disclosure controls and procedures, revised the wording of the Act's Section 302 certifications, and relocated the Section 302 and 906 certifications. These certifications must now be provided as exhibits to the periodic reports to which they relate.

See our July 2003 *Financial Reporting* letter for further details.

In addition to mandating the audits of internal control discussed

above, the Act directed the PCAOB to establish professional standards for auditors to follow in performing this work. Accordingly, the PCAOB has proposed a new auditing standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements*. This proposal has been controversial for a number of reasons:

- Lack of preparer guidance – The proposed standard requires an auditor to express an opinion covering a subject matter that is effectively undefined. This is because the preparer community lacks effective guidance relating to the extent of documentation and testing required to meet its responsibilities. In the absence of such guidance, issuers and auditors must apply considerable judgment. As a result, practice is likely to be inconsistent.
- Cost – The proposed standard prescribes a number of procedures an auditor must perform. In many cases, those procedures go well beyond the traditional audit concept of testing and examining evidence. Requiring auditors to perform all of these procedures may unnecessarily raise the cost of internal control audits.
- Timing – The new standards will need to be applied soon (beginning with internal control audits of companies with June 2004 year-ends). After the PCAOB revises its proposal to respond to comments, it will send it to the SEC for approval. Then the SEC will solicit comments on the revised proposed standard before approving it. When a final standard is finally issued, there could be little time for some issuers and their auditors to complete all the work it requires.

The proposed standard is available on the PCAOB's website

(<http://www.pcaobus.org/rules/Release2003-017.pdf>).

Improper Influence on Conduct of Audits (Release 34-47890)

The SEC adopted rules in April that implement Section 303 of the Act. Section 303 makes it unlawful for officers and directors of an issuer, and persons under their direction, to improperly influence the auditor of the issuer's financial statements. The SEC adopted new Exchange Act Rules 13b2-2(b) and (c), which prohibit an officer or director of an issuer, or any other person acting under the direction thereof, from directly or indirectly taking any action to coerce, manipulate, mislead, or fraudulently influence any auditor performing an audit or review of the financial statements of that issuer if that person knew or should have known that such action, if successful, could result in rendering such financial statements materially misleading. The Commission does not intend to hold any party accountable for honest and reasonable mistakes or to sanction those who actively debate accounting or auditing issues.

The rules took effect June 27, 2003.

See our July 2003 *Financial Reporting* letter for further details.

Audit Records Retention Requirements (Release 33-8180)

In January, the SEC adopted rules that require accounting firms to retain records relevant to their audits and reviews for seven years after they conclude an audit or review.

The rules require an auditor to retain records relevant to an audit or review, including (1) workpapers and other documents that form the basis of the audit or review and (2) memoranda, correspondence,

communications, and other documents and records (including electronic records) that:

- Are created, sent, or received in connection with the audit or review and
- Contain conclusions, opinions, analyses, or financial data related to the audit or review.

The new requirements were effective October 31, 2003.

See our March 2003 *Financial Reporting* letter for further details.

Code of Ethics Disclosures (Release 33-8177)

In January, the SEC adopted rules that require a company to disclose whether it has adopted a code of ethics for its principal executive and senior financial officers and, if not, the reasons why not, as well as any changes to, or waiver of any provision of, that code of ethics.

These new disclosures must be provided in the annual reports of all issuers, including small business issuers and foreign private issuers, other than registered investment companies. (In a separate release, the SEC adopted similar rules for investment companies.)

In addition, a company must make its code of ethics publicly available, and it has three alternatives for doing so. It may:

- File a copy as an exhibit to its annual report;
- Post its code on its website (if a company chooses this option, it must disclose its website address and intent to provide disclosure in this manner in its annual report); or
- Provide an undertaking in its annual report to provide a copy of its code to any person without charge upon request.

A company must also report changes to, or waivers of, its code of ethics on Form 8-K within five business days after the event occurred. If certain conditions are

met, a company can disseminate the required information using its website in lieu of filing Form 8-K. The Form 8-K reporting requirement does not apply to foreign private issuers, but they must disclose any such events that occurred during the past fiscal year in their annual reports.

Code of ethics disclosures are required in annual reports for fiscal years ended on or after July 15, 2003.

See our March 2003 *Financial Reporting* letter for further details.

Standards of Conduct for Attorneys (Release 33-8185)

The SEC adopted rules in January that established standards of conduct for attorneys. The rules are intended to protect investors and increase their confidence in public companies by ensuring that attorneys who work for those companies do not ignore evidence of material misconduct. They prescribe minimum standards of professional conduct for attorneys appearing and practicing before the Commission. These standards require attorneys to report actual or potential material violations of laws or breaches of fiduciary duty “up the ladder” within an issuer.

The rules were effective August 5, 2003.

In addition to up the ladder reporting, the Commission proposed (but has not adopted) rules that would require reporting outside the company in those rare cases where an attorney believes a violation is occurring and the company has not responded appropriately. One proposal would require attorneys to make a “noisy withdrawal” through which they would disaffirm a document or filing involving a violation. An alternative proposal would require the issuer, instead of the attorney, to disclose the attorney’s withdrawal to the Commission.

See our March 2003 *Financial Reporting* letter for further details.

MD&A Disclosure – Off-Balance Sheet Arrangements and Contractual Obligations (Release 33-8182)

In January, the Commission amended its MD&A rules to require a company to provide:

- A comprehensive explanation of its off-balance sheet arrangements and
- An overview of its aggregate contractual obligations in a tabular format.

These new disclosure requirements apply to all issuers, including small business issuers and foreign private issuers, except that small business issuers are not required to provide the tabular disclosure of contractual obligations. The rules do not apply to registered investment companies.

These rules are summarized below. See our March 2003 *Financial Reporting* letter for further details.

Off-Balance Sheet Arrangements

Companies must disclose information about their off-balance sheet arrangements in quarterly and annual reports and in registration statements. The disclosure must be presented in a separately captioned section of MD&A. The rules follow current MD&A guidelines, requiring a company to discuss an off-balance sheet arrangement only if it is reasonably likely that the arrangement will have an effect on the company that is material to investors.

A company must disclose the following, to the extent necessary to an understanding of its off-balance sheet arrangements:

- The nature and business purpose of the arrangements;
- The importance of the arrangements to the company for its liquidity and capital resources, market risk or credit risk support, or other benefits;

- The amounts of revenues, expenses, and cash flows arising from off-balance sheet arrangements;
- The nature and amounts of any interests retained, securities issued, and other indebtedness incurred in connection with such arrangements;
- The nature and amounts of any other material obligations or liabilities (including contingent obligations or liabilities) arising from such arrangements and the triggering events that could cause them to arise; and
- Reasonably likely terminations or material reductions in the availability of off-balance sheet arrangements that provide material benefits to the company, and the course of action the company will take or plans in response to any such circumstances.

Generally, the disclosures should cover the most recent fiscal year. However, the discussion should address changes from the previous year where necessary to an understanding of the disclosure.

These disclosures are required in registration statements, annual reports, and proxy materials that are required to include financial statements for fiscal years ended on or after June 15, 2003.

Contractual Obligations

Companies (other than small business issuers) must also provide a table presenting their aggregate contractual obligations. Although the table may be presented in any location within MD&A, it is intended to serve as a focal point of the liquidity discussion. The table should present information as of the end of the most recent fiscal year. In interim period MD&As, companies should update the information by disclosing material changes outside the ordinary course of business that have taken place since the most recent fiscal year-end.

The table must cover both on- and off-balance sheet items. It must present aggregate amounts due, by type, for the following types of obligations:

- Long-term debt;
- Capital lease obligations;
- Operating leases;
- Purchase obligations; and
- Other long-term obligations reflected on the balance sheet.

Amounts due in less than one year, one to three years, three to five years, and more than five years must be provided for each category. Companies should provide footnotes that describe provisions that create, increase, or accelerate obligations and other information necessary to understand the timing and amount of the obligations covered by the table.

This table is required in registration statements, annual reports, and proxy materials that are required to include financial statements for fiscal years ended on or after December 15, 2003.

Use of Non-GAAP Financial Measures (Release 33-8176)

In January, the SEC adopted rules that address disclosure issues related to “pro forma,” or “non-GAAP,” financial measures in filings with the SEC and in other public disclosures. The Commission addressed these issues in three ways:

- New Regulation G covers public disclosures that include non-GAAP measures, both disclosures that are filed with the SEC and those that are not. It prohibits using non-GAAP measures in a misleading manner and requires companies that disclose non-GAAP measures to provide specified information.
- Amendments to Regulations S-K and S-B and Form 20-F cover disclosures in SEC filings.

They require more extensive disclosures than does Regulation G. They also prohibit companies from presenting certain types of non-GAAP measures. These rules are discussed further below.

- Amendments to Form 8-K require companies to furnish the text of earnings releases and announcements with the SEC, regardless of whether the release includes a non-GAAP measure.

When a company discloses a non-GAAP measure in an SEC filing, it must:

- Present, with equal or greater prominence, the most directly comparable GAAP measure;
- Quantitatively reconcile the non-GAAP measure to the most directly comparable GAAP measure;
- State the reasons why management believes the non-GAAP measure provides useful information to investors; and
- To the extent material, state any additional purposes for which management uses the non-GAAP measure.

In addition, a company must *not*:

- Exclude charges or liabilities that required or will require cash settlement from non-GAAP liquidity measures (EBIT and EBITDA measures are excluded from this prohibition);
- Eliminate non-recurring, infrequent or unusual items if they are likely to recur within 2 years or there was a similar item within the prior 2 years;
- Present non-GAAP measures on the face of or in the notes to the financial statements;
- Present non-GAAP measures on the face of Regulation S-X Article 11 pro forma financial information; and
- Use titles or descriptions that are the same as, or confusingly similar to, titles or descriptions used for GAAP measures.

These rules were effective March 28, 2003.

See our March 2003 *Financial Reporting* letter for further details.

In June, the SEC staff published an FAQ document covering these rules. This document is available on the SEC's website (<http://www.sec.gov/divisions/corpfin/faqs/nongaapfaq.htm>). The FAQ addresses 33 questions covering the following topics:

- Transition issues
- Business combination transactions
- Item 10(e) of Regulation S-K
- EBIT and EBITDA
- Segment Information
- Item 12 of Form 8-K
- Foreign Private Issuers
- Voluntary filers

In subsequent discussions and speeches, the staff has commented on common problems in applying the new rules. The issues the staff seems to mention most frequently are:

- The high disclosure hurdle companies must meet to justify presenting non-GAAP measures that exclude recurring items (for example, when a company presents EBITDA as a measure of operating performance) and
- The quality of the disclosures companies provide to explain why measures are useful to investors and how they are used by management (the staff expects more substantive disclosures, rather than boilerplate language).

See our February 2004 *Financial Reporting* letter for further details.

Insider Trades During Pension Fund Blackout Periods (Release 34-47225)

In January, the SEC adopted rules that apply to public companies that sponsor individual account

plans through which participants invest in company equity securities. During "blackout" periods, investors cannot transfer balances between investment options.

The rules are contained in new Regulation Blackout Trading Restriction (BTR). Regulation BTR prohibits directors and executive officers from trading company equity securities during a blackout period. It applies to directors and executive officers of domestic issuers, foreign private issuers, small business issuers and, in rare instances, registered investment companies.

Regulation BTR also requires companies to notify directors and officers of an impending blackout period. Domestic companies, including registered investment companies (who are otherwise exempt from Form 8-K filing requirements), must also notify the SEC by filing the notice on new Item 11 of Form 8-K. The Form 8-K must be filed on the same date the notice is transmitted to directors and executive officers. Foreign private issuers are not required to file Form 8-K but must file as an exhibit to their annual reports on Forms 20-F or 40-F all notices provided to officers and directors during the year.

Regulation BTR was effective January 26, 2003. The requirement to file the notices on Form 8-K was effective March 31, 2003.

See our March 2003 *Financial Reporting* letter for further details.

Electronic Filing and Website Posting of Forms 3, 4 and 5 (Release 33-8230)

In April, the Commission adopted rules pursuant to Section 403 of the Act. Effective August 29, 2002, Section 403 required insiders to file reports of ownership changes within two business days. Section 403 also mandates the

electronic filing, and website posting by issuers with corporate websites, of insiders' beneficial ownership reports (Section 16 reports, i.e., Forms 3, 4 and 5). This rule-making implemented the electronic filing and website posting requirements.

The website posting rules require an issuer that maintains a corporate website to post on that website all Forms 3, 4 and 5 filed with respect to its equity securities by the end of the business day after filing. An issuer may satisfy this requirement by providing direct access to the filings or by hyper-linking to a third-party website (such as EDGAR) if certain conditions are satisfied.

The rules were effective June 30, 2003.

Equity Securities Purchases by the Issuer (Release 33-8335)

In October, the Commission adopted new rules that will require issuers to disclose in Exchange Act periodic reports all repurchases (in open market or private transactions) of their equity securities. The disclosure requirements apply to domestic issuers, including small business issuers, foreign private issuers, and registered closed-end management investment companies.

As part of this rulemaking, the SEC also amended Exchange Act Rule 10b-18. That rule offers issuers a type of "safe-harbor" protection against liability for market manipulation claims under federal securities laws in connection with repurchases of their securities in certain circumstances. The amendments simplify and update the safe harbor provisions to reflect market developments since that rule was adopted.

Under the new rules, issuers will be required to provide tabular

disclosure of information regarding equity securities purchased during each month of the period covered by the report, regardless of whether the repurchases were effected in accordance with Rule 10b-18. The table must provide the following information:

- The total number of shares purchased;
- The average price paid per share;
- The total number of shares purchased during the month as part of publicly announced share repurchase plans; and
- The maximum number of shares that may yet be purchased under share repurchase plans.

The table must also include footnotes that provide information about publicly announced share repurchase programs and shares purchased other than through share repurchase programs.

The new disclosures will be required in Forms 10-Q and 10-QSB, 10-K and 10-KSB, 20-F, and N-CSR. The disclosures must first appear in domestic issuers' reports for periods ending on or after March 15, 2004. Foreign private issuers must provide the new disclosures in reports on Form 20-F for periods ending on or after December 15, 2004. Registered closed-end management investment companies must provide the disclosure in Form N-CSR with respect to any repurchases during any calendar month following June 2004.

Director Nomination and Shareholder Communication Processes (Releases 33-8340 and 34-48626)

In November, the Commission adopted rules designed to make the operation of boards of directors more transparent to shareholders.

The rules are outlined in Release 33-8340. They require issuers to provide a number of specific and detailed disclosures regarding the company's process for nominating directors and the process by which shareholders can communicate with the board. The disclosures are required in proxy materials covering elections of directors. In addition, if there is a process for shareholders to submit director candidates and there is a material change in that process, the change must be reported in the Exchange Act periodic report (e.g., 10-Q, 10-K) covering the quarter in which the change occurred. The rules apply to domestic issuers (including small business issuers), and similar disclosure requirements were adopted for registered investment companies.

The disclosures are required in proxy materials that are first distributed on or after January 1, 2004 and in periodic reports for the first reporting period ending after January 1, 2004.

In addition, for the first time in its history, the Commission proposed (but has not adopted) rules that would change the director election process by requiring the issuers referred to above to, in certain circumstances, include in their proxy materials the names of shareholder nominees for election as a director. These proposed rules are outlined in Release 34-48626. This proposal is controversial, and the SEC has received thousands of comment letters on it.

Commission and Staff Guidance

Results of Fortune 500 Company Report Reviews

During 2002 the SEC staff undertook a project to review the annual

reports of the Fortune 500 companies. In February 2003, the staff published a report that discusses the most common issues addressed in those reviews. The staff has informally indicated that these issues will likely be the focal points of its reviews of 2003 reports. The summary is available on the SEC's website (www.sec.gov/divisions/corpfin/fortune500rep.htm).

See our February 2004 *Financial Reporting* letter for further details.

MD&A Interpretive Guidance (Release 33-8350)

In December, the Commission issued an interpretive release that provides guidance regarding preparing MD&A. The Release does not create new or modify existing requirements. Rather, it provides guidance to help companies prepare MD&A disclosures that are easier for investors to understand and better satisfy the objectives of MD&A. The Release provides guidance regarding:

- Improving the overall presentation and focus of MD&A;
- Providing meaningful analysis as opposed to uninformative discussion;
- Quantifying known material trends and uncertainties;
- Using key performance indicators;
- Improving liquidity and capital resources disclosure; and
- Providing more insightful critical accounting estimates disclosures.

The Release is available on the SEC's website (www.sec.gov/rules/interp/shtml).

See our February 2004 *Financial Reporting* letter for further details.

SAB Codification Update

In May, the Commission's staff issued Staff Accounting Bulletin (SAB) 103, *Update of Codification of Staff*

Accounting Bulletins. SAB 103 generally did not provide new guidance. Rather, it updated the existing SAB codification. It revised or rescinded portions of the guidance in the previous SAB codification to make it consistent with current accounting and auditing literature and Commission rules and regulations. The SAB contains a summary of the changes made. SAB 103 is available on the SEC's website (www.sec.gov/interps/account/sab103.htm).

SAB 104

The Commission's staff issued SAB 104, *Revenue Recognition*, in December. The SAB updated portions of the interpretive guidance

in Topic 13 of the *Codification of Staff Accounting Bulletins* to make it consistent with current authoritative accounting literature.

The principal revisions consisted of incorporating certain sections of the staff's FAQ document on revenue recognition into Topic 13. SAB 104 also deleted guidance no longer necessary because of recent developments in U.S. GAAP (primarily the issuance of EITF 00-21, *Revenue Arrangements with Multiple Deliverables*, and EITF 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent*).

SAB 104 is available on the SEC's website (www.sec.gov/interps/account/sab104.htm).

For Further Information

If you would like further information or to discuss the implications of these matters, please contact the BDO Seidman, LLP engagement partner serving you or one of the following partners:

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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.