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SEC Comment Letters on Domestic Registrants

A Closer Look



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Domestic Registrants

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Preface

Section 408(c) of the Sarbanes-Oxley Act of 2002 requires the SEC staff to review every issuer's disclosures, including financial statements, at least once every three years. The SEC staff's comments and registrants' responses are posted on EDGAR and provide valuable insight into areas of SEC staff focus. Registrants can incorporate a review of the comments into their financial reporting process to help improve their financial statements and disclosures. In this Special Report, we give examples of frequently issued SEC staff comments on several key topics, along with additional analysis and links to related resources.

Many of the topics are probably already familiar. The SEC staff has been issuing comments on topics such as revenue recognition, business combinations, segment reporting, financial instruments, and impairments for years. We expect the staff to continue to issue comments on these topics. The staff also has been issuing comments on new areas within some of these topics. In recent years, for example, the staff has been more closely scrutinizing the identification of and accounting for acquired customer-related intangibles. Other examples? As the products that we use every day include more technology, more registrants need to consider software revenue recognition guidance. As convertible securities have become a more broadly used, low-cost means of raising capital, the staff has increased its scrutiny of registrants' accounting for and classification of these securities.

In addition to the old standbys, we cover some topics on which the staff is just beginning to issue comments, and we expect the staff to frequently comment on these topics in the year ahead. One topic the staff has begun to scrutinize is Interpretation 48,¹ which covers the accounting for and disclosure of uncertain tax positions. In addition, disclosures regarding the impact of the current turbulent debt and equity markets will be front and center as staff reviewers start looking at 2007 filings. The increase in fair value measurements has led to staff comments about the inclusion of consents in registration statements in which a registrant refers to its use of an expert (such as a valuation specialist).

¹ For the full title of each standard, see [Appendix E: Glossary of Standards](#).

SEC Comment Letters on Domestic Registrants

A Closer Look

We also cover SAB 74, which requires disclosures about the effects of recently issued accounting pronouncements that are not yet effective. The SEC staff may issue comments to registrants when they do not give investors a clear picture of how new standards, such as Statements 157, 159, 141(R), and 160, affect them.

While the SEC staff comments provide registrants with helpful information about reviews of past filings, at the annual AICPA National Conference on Current SEC and PCAOB Developments (the “AICPA Conference”) each December, regulators and standard setters give preparers updates on recent accounting, auditing, and SEC rules as well as a look inside their areas of focus for the reporting season ahead. Each year, we prepare a comprehensive *Heads Up* newsletter covering the remarks made at the conference. In this Special Report, we include excerpts from, and links to, *Heads Up* issues, where relevant. The complete issues are available at www.deloitte.com.

Our appendixes offer additional valuable insights. For example, [Appendix A](#) offers a glimpse into the SEC staff’s methods for selecting and reviewing filings, and [Appendix B](#) discusses best practices for managing unresolved SEC comment letters.

Is your company a foreign private issuer? If the SEC ultimately accepts domestic registrants reporting in IFRSs, is your company considering filing IFRS financial statements? If you answered yes to either question, you might be interested in our companion publication, “[SEC Comment Letters on Private Foreign Issuers Using IFRSs: A Closer Look.](#)”

We hope that you find this Special Report a valuable tool for improving your financial statements. We welcome your feedback. Please [send](#) us your thoughts and suggestions.

Many hands and minds contributed to this Special Report. Christine Davine, Lisa Delfini, and Nedra Downing led its development and were principal authors. We would also like to thank contributing authors and reviewers Jim Johnson, Robin Kramer, Mark Miskinis, Lisa Mitrovich, Stuart Moss, Magnus Orrell, Randall Sogoloff, Bob Uhl, Karen Wiltsie, Brandon Campbell, Jeff Minick, and Chris Rogers. In addition, we appreciate the efforts of the Production Group, including Lynne Campbell, Yvonne Donnachie, Michael Lorenzo, Joan Meyers, Jeanine Pagliaro, and Joseph Renouf.

Business Combinations, Long-Lived Assets, and Impairments

Examples of SEC Comments

- *Purchase Price Allocations* — We note that the excess of the purchase price over the net assets acquired . . . resulted in goodwill of approximately [\$750 million]. In future filings where you discuss a material acquisition, please include a discussion of the factors that contributed to a purchase price that resulted in recognition of a significant amount of goodwill. Refer to paragraph 51(b) of SFAS 141.
- *Customer Relationships* — It is unclear from your disclosures whether you amortize your customer relationship intangible assets on a straight-line basis or accelerated basis. Please tell us and disclose the method used. Further, paragraph 12 of SFAS 142 requires companies to amortize identifiable intangible assets using a method that reflects the pattern in which the economic benefits of the assets will be consumed. The straight-line method of amortization should be used if the company cannot reliably determine that pattern. We believe the benefits from acquisition of customer relationships within a large group of accounts tend to dissipate more rapidly in the earlier years after a company acquires the contracts. The rate of decrease of benefits will slow until relatively few customers . . . remain. In these situations, we believe that an accelerated method of amortization is the most appropriate way to allocate the cost of the customer relationship to the periods that will benefit from the relationship. The straight-line method is appropriate only if the estimated life of the intangible asset is shortened to ensure that recognition of the cost of the revenues better corresponds with the distribution of expected revenues.
- *Impairments* — Taking into consideration the circumstances that caused you to recognize an impairment charge on the . . . goodwill, tell us whether you first tested your long-lived assets pursuant to SFAS 144. If you did test your long-lived assets for impairment, explain to us why an impairment charge was not recognized. If you have not tested your long-lived assets for impairment, explain to us why not. Please also tell us how you group your long-lived assets for purposes of testing your long-lived assets for impairment using the guidance of paragraphs 10–12 of SFAS 144.

Purchase Price Allocations

The SEC staff frequently asks questions about purchase price allocations for material business combinations. In particular, the staff has asked companies that have recorded significant goodwill why the goodwill was not attributed to specified intangible assets, and has requested that companies disclose the factors that contributed to a purchase price that resulted in significant goodwill.

The SEC staff has often referred to information included in a filing that indicates that an intangible asset was acquired, but not recorded in the purchase price allocation. For example, registrants that disclosed in their Management's Discussion and Analysis (MD&A) that they acquired contracts with customers in a business combination, but that did not disclose the related intangible assets, have been asked why not. In addition, the SEC staff may ask detailed questions about material revisions to an initial purchase price allocation. For example, the SEC staff has asked what significant assumptions have changed that support a revision to the value of intangible assets.

Intangible Assets — Customer Relationships

Another area the SEC staff has addressed relates to the accounting for customer relationships. The SEC staff has asked registrants to justify "long" useful lives for customer relationships, sometimes asking for an analysis of customer attrition rates. For example, a registrant may be asked to substantiate a useful life exceeding five to ten years. The SEC staff has also issued comments about the use of straight-line versus accelerated amortization methods. Paragraph 12 of Statement 142 requires entities to amortize identifiable intangible assets using a method based on the pattern in which the economic benefits of the assets are consumed, and it prohibits the use of the straight-line method unless the pattern cannot be determined. Consequently, the SEC staff has challenged registrants that use the straight-line method, even when useful lives are short, and has requested that they support an assertion that they are unable to determine the pattern in which the economic benefits of the assets are consumed. The SEC staff's comments indicate that acquired customer relationships tend to benefit a company the most in the years immediately after acquisition, and that it is more appropriate to amortize these assets on an accelerated basis.

Statements 141(R) and 160

In December 2007, the FASB issued Statement No. 141(R), *Business Combinations*, and Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements*. Statement 141(R) elevates the role played by fair value and dramatically changes the accounting for business combinations. SAB 74 disclosures about the effects of these recently issued accounting pronouncements are required.

Impairments

In a report on restatements,² the Center for Audit Quality indicated that approximately 10 percent of the 1,876 restatements during 2006 related to property, plant, and equipment impairments or to intangible asset impairments. Although Statements 142 and 144 have been around since 2001, they continue to be an area of focus for both the SEC and the PCAOB. When impairment charges are recorded, the SEC staff may request that registrants either disclose or provide information to the SEC staff regarding the following:

- The adequacy and frequency of a registrant's asset impairment tests.
- The factors and/or indicators used by management to evaluate whether the carrying value of goodwill or other long-lived assets may not be recoverable.
- The methods and assumptions used in impairment tests.
- A sensitivity analysis that shows how fair value would fluctuate on the basis of hypothetical changes in assumptions.
- The timing of the impairment, especially if events that could result in impairments occurred in periods before the registrant recorded the impairment. Under these circumstances, the SEC staff may ask registrants to justify why the impairment was not recorded in the previous period.
- How many reporting units the registrant has and whether any have declining fair values.
- The types of events that could result in impairments.
- Fulsome disclosure in the critical accounting policies section of MD&A regarding the registrant's process for assessing impairments.
- The facts and circumstances leading to impairments, along with a reminder that disclosure in MD&A may be required for risks and uncertainties surrounding the recoverability of assets in periods before recording an impairment.

² Center for Audit Quality Report, "Offsetting Fluctuations Cause 2006 Financial Statement Restatement Increase of 17%; Non-Accelerated Filer Restatements Rise by 25%; Accelerated Filer Restatements Decline by 8%."

The SEC staff also frequently asks questions about how an entity groups assets for impairment tests, especially when the registrant's disclosure is not clear that goodwill is tested at the reporting unit level or that long-lived assets are tested for impairment at the asset group level. Further, the SEC staff encourages registrants to disclose (1) how reporting units are identified, (2) the allocation of goodwill to reporting units, and (3) whether there have been any relevant changes in the critical accounting policies section of MD&A.

Asset Grouping for Testing Long-Lived Assets for Impairment

An asset group is defined under Statement 144 as the "lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities." The SEC staff has frequently issued comments when the entity has tested long-lived assets at an operating or reportable segment, or reporting unit level, since there are often identifiable cash flows below this level. Determining the lowest level of identifiable cash flows often requires judgment. Registrants should begin at the lowest level of cash flows in the organization and group assets at a higher level only if appropriate. Registrants should consider the following factors in determining whether to group assets at a higher level: (1) the existence of shared costs, (2) the interdependence of assets, and (3) the extent to which purchases are made on a combined basis.

Asset Grouping for Testing Goodwill for Impairment

Statement 142 indicates that goodwill should be tested for impairment at the reporting unit level. Reporting units are defined as (1) an operating segment (as defined in Statement 131) or (2) "one level below an operating segment (referred to as a component)." A component is a reporting unit if it "constitutes a **business** for which **discrete financial information** is available and **segment management regularly reviews the operating results.**" [Emphasis added and footnotes omitted] A company must consider the requirements of Issue 98-3 in determining whether a component is a business. "Discrete financial information" is discussed in paragraph 10 of Statement 131 and in Questions 3 and 4 of the related FASB staff implementation guide, and "segment management" is defined in paragraph 14 of Statement 131. Two or more components of an operating segment may be aggregated into a single reporting unit if they share similar economic characteristics. EITF Topic D-101, as well as the guidance in

paragraph 17 of Statement 131 on similar economic characteristics, is helpful in making this determination. In addition, the [SEC's Current Accounting and Disclosure Issues in the Division of Corporation Finance](#) (as updated November 30, 2006) states, in part, the following:

While the components of an operating segment may be aggregated for the purposes of goodwill impairment testing and considered a single reporting unit if the components have similar economic characteristics, it is not permissible to aggregate separate operating segments into one reporting unit. At a minimum, each operating segment is a reporting unit under SFAS 142 that should be tested separately. Additionally, registrants should not aggregate components from different operating segments that share similar economic characteristics into a single reporting unit.

SEC Staff Remarks at the AICPA Conference

SEC staff members provide insights on business combinations and impairments each year at the AICPA Conference. See Deloitte & Touche LLP's [December 20, 2007, Heads Up](#) on the 2007 Conference for summaries of SEC staff comments on the use of a replacement cost approach to valuing intangible assets and determining the acquirer in a business combination. Summaries of SEC staff comments on other business combinations and impairment issues can also be found in Deloitte & Touche LLP's [December 21, 2006](#), and [December 23, 2005, Heads Ups](#).

Other Deloitte & Touche LLP Resources

- [December 12, 2007 \(revised December 19, 2007\), Heads Up, "To Merge and Converge: Major Changes to Business Combination Accounting as FASB and IASB Substantially Converge Standards."](#)
- [Accounting for Business Combinations, Goodwill, and Other Intangible Assets: A Roadmap to Applying Statements 141 and 142.](#)

Contingencies

Example of SEC Comments

- Please revise to provide the disclosures required by paragraphs 8, 9 and 10 of SFAS 5, or tell us why you believe such disclosures are not required. Specifically, please disclose the nature of accrual(s) made pursuant to paragraph 8 of SFAS 5 and if material, the amount of such accrual(s). If no accrual is made because one or both of the conditions in paragraph 8 are not met, or if an exposure to loss exists in excess of the amount(s) accrued, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or additional loss may have been incurred. The disclosure should provide an estimate of the possible loss or range of loss or state that such an estimate cannot be made.

The SEC staff and investors have expressed concern about the lack of timely and transparent disclosures for contingencies. Disclosures often lack sufficient information for users to understand the nature of each contingency and amount of loss accrued. Registrants sometimes also fail to disclose the range of loss when no amount is accrued because the loss is only reasonably possible (rather than probable). Registrants should ensure that disclosures for contingencies are specific and not generic.

The *SEC's Current Accounting and Disclosure Issues in the Division of Corporation Finance* (as updated November 30, 2006) states, in part:

Registrants, their auditors, and their advisors have a responsibility to critically assess the claims against the company in order to identify those for which losses should be accrued and those that are not accrued because the success of the claim is only reasonably possible. Disclosure should discuss the nature of the claim, the amount accrued, if any, and the possible range of loss for claims where any amount within the range of reasonably possible loss is material. Circumstances where a loss was accrued for a claim without disclosure in prior filings of the nature of the claim and the range of reasonably possible loss should be rare due to the nature of most contingencies. A registrant that accrues a significant loss for a contingency, but whose prior disclosure of the low end of the range of reasonably possible loss was zero with no loss accrued, should ensure that there is robust disclosure that explains what triggered the significant loss in the period in which it was recorded.

The SEC staff's comments in this area can be categorized as follows:

- Lack of quantification of amounts accrued, if any, and possible loss or range of loss (or disclosure about why such an estimate cannot be made).
- Insufficient detail of new developments and their impact on current and future periods.
- Insufficient detail of judgments and assumptions underlying significant accruals.
- Significant current-period accruals without any prior disclosure, or previous disclosure with the accrual set at the low end of the range.
- Lack of disclosure about why no accrual estimate can be made.
- Broad, general disclosures made in the aggregate only.

In addition, inconsistent or unclear information in a registrant's filing often triggers SEC staff comments. For example, the SEC staff has challenged registrants that have (1) disclosed in their footnotes that the outcome of a contingency is not expected to materially affect their financial statements but (2) disclosed in the risk factors section of the filing that the same contingency's outcome could materially affect their financial results. Registrants have been asked to explain this inconsistency and why they believe that the contingency's outcome would not materially affect their financial results.

The FASB has recently added to its agenda a project to consider enhancing disclosure requirements for contingencies to address concerns that information related to significant contingencies is not being disclosed timely in the financial statements. Registrants should watch for project details, since any final guidance may include new disclosure requirements related to loss contingencies.

Discontinued Operations and Assets Held for Sale

Examples of SEC Comments

- *Discontinued Operations Reporting* — Please tell us why these store closures were recorded as restructurings rather than presented as discontinued operations. Since [Company X] was historically a reportable segment, it appears that this would meet the criteria as a component of an entity, and therefore, be reported as discontinued operations. Refer to SFAS 144 and EITF 03-13.
- *Discontinued Operations Reporting* — Please tell us the significance of the . . . contracts that are part of your disposal strategy [related to the disposed entity]. . . . In this regard, please tell us if the contracts constitute significant continuing involvement in the operations of the disposed entity as the term is described in paragraph 42 of SFAS No. 144. Furthermore, please tell us how this was considered when you reported the component as a discontinued operation.
- *Assets Held for Sale* — We note from your disclosure . . . that in [December 2006] you announced a plan to sell [five plants]. Please tell us if the assets of these [five plants] have been classified as held-for-sale as of [December 31, 2006] in accordance with paragraph 30 of SFAS No. 144. If the assets have not been classified as held-for-sale, please explain to us why not.
- *Expense Allocation* — Please tell us how and whether you allocated interest expense associated with the discontinued operations. We assume you allocated actual expense of assumed debt. Please tell us whether any other allocations of interest expense were made and the method you utilized. Please note the disclosure requirements of EITF 87-24. As a final note, to the extent interest allocations of discontinued operations affected interest expense of continuing operations, this should be analyzed in management's discussion and analysis of interest expense.

Discontinued Operations Reporting

The SEC staff may question a registrant that disposes of operations that are not presented as discontinued operations. Conversely, it may question why a registrant accounts for operations as discontinued when the registrant will have cash flows from or continuing involvement with the disposed operations. Statement 144 requires companies

to report their results related to disposed-of or held-for-sale components as discontinued operations when the following conditions exist:

- (a) the operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity as a result of the disposal transaction **and**
- (b) the entity will not have any significant continuing involvement in the operations of the component after the disposal transaction. [Emphasis added]

Application of the criteria in Statement 144 can be subjective. Issue 03-13 provides guidelines for determining:

- *Whether the registrant expects continuing direct cash flows from the disposed component after the disposal transaction.* Questions to consider include the following:
 - o Has there been a migration of revenues or costs from the disposed component?
 - o Is there a continuation of activities of the disposed component?
 - o Has the significance of continuing cash flows been measured by comparing the expected continuing cash flows to the cash flows that would have been recognized in the absence of the disposal transaction?
- *Whether the registrant has the ability to exert significant influence over the disposed component's operating and financial policies after the disposal transaction.* Questions to consider include the following:
 - o Are there considerations other than risks and rewards in determining whether the ongoing entity has significant continuing involvement?
 - o Are there retained interests, contracts, and other arrangements that may indicate significant continuing involvement?

Frequently, the SEC staff seeks to understand whether the registrant has continuing involvement with the disposed component. The staff may refer to information included in a filing that indicates possible continuing involvement. For instance, the staff may ask detailed questions about the nature and significance of contracts with the discontinued component that the registrant has disclosed (e.g., a contract to continue to manufacture or market the component's products).

Assets Held for Sale

Another area that has generated comments relates to classifying assets as held for sale. The SEC staff frequently comments when disclosures indicate that assets were sold but are unclear about when the decision to sell the assets was made. For example, the

staff has asked registrants that have disclosed that they sold assets after the balance sheet date, but did not classify the assets as held for sale at that balance sheet date, to submit additional disclosures and supporting documentation to explain the nature and significance of the transaction. Registrants have been asked to supply the following types of information:

- The carrying amount and classification as of the balance sheet date of the assets and liabilities included in the subsequent sale.
- The gain or loss on the asset sale.
- The timeline of events leading to the asset sale.
- The sales agreement and a description of how the agreement affected the determination that held-for-sale presentation was not appropriate.

Timing of Impairments

The SEC staff frequently questions the appropriateness and timeliness of a registrant's impairment tests when assets or components are disposed of or discontinued. For example, the staff may ask whether assets that were expected to be sold or disposed of by the registrant were tested for impairment in prior periods. If the registrant performed an impairment test, the SEC staff may request a copy of the related documentation. If the registrant did not perform an impairment test, the staff will most likely expect an explanation. Refer to the [Business Combinations, Long-Lived Assets, and Impairments](#) section for further discussion.

Expense Allocation

The SEC staff will sometimes ask for additional information about the allocation of expenses, such as interest expense, in reporting discontinued operations. The staff may ask how the method for allocating interest expense complies with Issue 87–24.

Discontinued Operations in the Statement of Cash Flows

The SEC staff will also frequently challenge inappropriate presentation of discontinued operations in the statement of cash flows. Refer to the [Financial Statement Classification — Income Statement and Statement of Cash Flows](#) section for further discussion.

Earnings per Share

Examples of SEC Comments

- *Two-Class Method* — Tell us what consideration you gave to computing earnings per share for both Class A and Class B common shares pursuant to the two-class method. Refer to paragraphs 60 and 61 of SFAS 128. We note from your disclosure . . . that each class of common stock participates equally, however, it appears that you may have a material number of dilutive securities in Class A common stock, which may result in different diluted EPS for the two classes.
- *Impact of Convertible Instruments on EPS* — We note from your disclosure, Class A and B shares are considered as one class for purpose of the earnings per share computation. Tell us what consideration you have given to the two-class method for computing basic and fully diluted earnings per share for each of your issued and registered Class A and Class B common stock. In this respect, tell us what consideration you gave to presenting Class A common stock on a fully diluted “if converted” basis reflecting the conversion of Class B common stock into Class A common stock. We refer you to paragraph 61.d of SFAS 128.
- *EPS Disclosures* — Please revise future filings to disclose the number of securities that could potentially dilute EPS in the future, but which were not included in the calculation of diluted EPS because to do so would have been antidilutive for the periods presented. See paragraph 40 of SFAS No. 128.

Two-Class Method

The two-class method generally applies to securities that participate in earnings but are not convertible into common stock; it also applies when multiple classes of common stock are outstanding. When the SEC staff sees information in a registrant’s filing indicating that the registrant has two classes of common stock that are treated as one class for purposes of calculating earnings per share (EPS), the SEC staff often asks whether the registrant considered the two-class method in computing EPS pursuant to Issue 03-6 and paragraphs 60–61 of Statement 128.

The SEC staff may ask registrants to substantiate the method used to calculate EPS (e.g., the two-class method, the if-converted method). In such circumstances, the SEC staff may request additional information or disclosures relating to each of the registrant’s classes of common stock, preferred stock, and common stock equivalents, such as convertible securities, warrants, or options. For example, the SEC staff has requested

that registrants disclose each class of common stock's rights and privileges, including any liquidation preferences. When the registrant has preferred shares, the SEC staff may seek to determine whether the preferred stockholders have contractual rights to share in profits and losses of the company beyond the stated dividend rate.

At the 2006 AICPA Conference, Ms. Cathy Cole, associate chief accountant in the SEC's Office of the Chief Accountant, stressed the importance of evaluating the rights associated with each class of stock, stating in prepared remarks:

[W]hen applying the two-class method to several classes of common stock, one ought to consider all of the rights and privileges of the classes in determining the allocation of undistributed earnings to the individual classes of common stock. And, for good measure, you may want to ask the staff, about the issue as well.

See Deloitte and Touche LLP's *Heads Up* on the 2006 AICPA Conference for additional information on Ms. Cole's remarks. The SEC staff will most likely continue to focus on understanding the rights and privileges of each class of stock.

Impact of Convertible Instruments on EPS

The SEC staff has also commented on the EPS treatment of convertible instruments. For instance, Ms. Cole stated that the SEC expects that a company with two classes of common stock will present both basic and diluted EPS for each class of common stock, regardless of conversion rights. As indicated by Statement 128 and clarified by Issue 03-6, diluted EPS should be computed using the if-converted method for the nonconvertible class (the "converted into" class) if the effect is dilutive. Statement 128 requires registrants to compute diluted EPS for a convertible class using the two-class method when there is more than one class of common stock and the classes have different dividend rates.

The SEC staff has focused on understanding the terms associated with (1) the registrant's classes of common stock and (2) such stock's dividend rates. Information in filings may indicate that a registrant has excluded, in its basic EPS computation, redeemable convertible preferred stock that contains dividend rights. The SEC has asked such registrants (1) why the preferred stock was excluded from basic EPS, since the preferred stockholders appear to participate in earnings on the same basis as common shareholders, and (2) how the current computation of EPS complies with the requirements of Issue 03-6.

EPS Disclosures

The SEC staff often requests that registrants disclose additional information about how EPS was calculated. For example, the SEC staff may request that registrants disclose:

- How unvested stock, unvested stock units, unvested restricted stock units, and performance shares are treated in basic and diluted EPS.
- Whether stock options containing rights to dividend equivalents are treated as participating securities, and how participating securities are factored into the calculation of EPS.
- How stock held in treasury is treated in determining the common shares outstanding.
- The accounting policy on earnings/loss allocations to shareholders.
- The nature of incentive distribution rights.

Fair Value and the Turmoil in the Credit Markets

Examples of SEC Comments

- *Fair Value Measurement* — Please tell us what impact the recent turmoil in the credit market has had on your valuation and accounting for this investment.
- *Fair Value Measurement* — Please provide a detailed description of whether [the company] believes its financial condition, results of operations, or liquidity will be adversely affected by its involvement with subprime lending, including:
 - If an adverse impact is considered remote, support for that conclusion; or
 - If an adverse impact is not considered remote, a detailed description of potential disclosures considered.
- *Off-Balance-Sheet Exposure* — Please address all involvement with special purpose entities and variable interest entities and quantify the sub-prime exposure related to such entities, regardless of whether they are consolidated for the purposes of generally accepted accounting principles.

Overview

The deteriorating credit markets have underscored the need for transparent disclosure of a registrant's exposure to, and the impact of, potential credit losses. As the crisis has deepened, the SEC staff has focused keenly on the ability of a registrant to accurately portray its financial position. Recent comment letters and various speeches and publications produced by the SEC staff reflect this increased scrutiny. In early 2008, the SEC issued a letter clarifying the accounting ramifications of accelerated efforts to mitigate the subprime crisis related to securitized loans.

Fair Value Measurement

As a result of the turmoil and decreased liquidity in the credit markets, many registrants are forced to rely on internal valuation models that include inputs that cannot be obtained from current market information (unobservable inputs) when determining

the fair value of a significant portion of the financial assets recognized on their balance sheets. As the subjectivity in determining amounts recognized in the balance sheet increases, so does the need for comprehensive and transparent footnote disclosures. The issuance of Statement 157 has further emphasized the importance of transparency in the determination of fair value, especially when valuation models use unobservable inputs.

The SEC staff has issued numerous comments requesting that registrants provide additional disclosures about valuation methods and assumptions. At the 2007 AICPA Conference, Ms. Stephanie Hunsaker, associate chief accountant in the SEC's Division of Corporation Finance, highlighted several areas of increased scrutiny by the Division regarding fair value measurement. Ms. Hunsaker stated that the SEC staff believes that many registrants do not provide sufficiently insightful analysis about how they determine fair value, especially when fair value measurements rely on unobservable data. Ms. Hunsaker stated that the SEC staff believes registrants should consider the following financial statement disclosures when fair value measurements rely on unobservable inputs:

- The valuation models used to determine fair value.
- The significant inputs into the models.
- The assumptions that could have the greatest impact on the valuations.
- Whether, how, and why those assumptions have changed from prior periods.

In addition to the considerations noted by Ms. Hunsaker, registrants should, regardless of whether they have adopted Statement 157, consider the disclosure requirements provided in SOP 94-6 and Statement 107. SOP 94-6 requires disclosures about assumptions or estimates that have a significant impact on a registrant's financial statements, such as the registrant's use of significant unobservable inputs. The Center for Audit Quality also reminded registrants of the requirements in SOP 94-6 in a white paper entitled "Fair Value Measurements in Illiquid (or less Liquid) Markets." In that white paper, the CAQ suggested that registrants consider the need for Statement 157-like disclosures, even if not adopted, when significant unobservable inputs are used to value a significant portion of the assets on the registrant's balance sheet.

Ms. Hunsaker also noted that registrants that have early adopted Statement 157 should consider enhanced disclosure regarding fair value measurements that have been reclassified from Level 2 to Level 3 measurements during the year as a result of a decrease in market information. She stated that registrants should disclose the types of instruments that are reclassified to Level 3 and the nature of the inputs that are no longer observable.

Off-Balance-Sheet Exposure

Disclosure of off-balance-sheet exposures has also been the subject of SEC comment letters and was discussed at the 2007 AICPA Conference. In addition, the Division of Corporation Finance recently sent a [letter](#) to registrants requesting additional disclosure in MD&A of exposures to off-balance-sheet entities.³ The suggested disclosures focused on the following themes:

- Detailed descriptions of the assets and funding of off-balance-sheet entities.
- Any material difficulties that off-balance-sheet entities are experiencing (including asset write-downs or credit downgrades) and the impact to the registrant.
- Types of variable interests the registrant holds in off-balance-sheet entities.
- Detailed disclosure of support the registrant has provided or is obligated to provide to off-balance-sheet entities (including obligations to provide liquidity).
- The potential impact on debt covenants, capital ratios, credit ratings, or dividends should the registrant have to consolidate or incur losses associated with the entities.

In the letter, the SEC staff also provides specific disclosure considerations for the critical accounting estimates section of MD&A for registrants that have identified as a critical accounting policy the accounting for consolidation and variable interest entities. Such registrants should consider including the following disclosures in the critical accounting policies section of the footnotes:

- The scenarios in which the registrant would have to consolidate off-balance-sheet entities, and the expectation of the likelihood of such an event.
- The frequency with which the registrant reconsiders, and the typical triggers that require reconsideration of, whether the registrant is the primary beneficiary of the entity.

The letter also reminds registrants of the requirement in Regulation S-K, Item 303, to disclose any known trends or uncertainties reasonably expected by the registrant to have a material favorable or unfavorable effect on income from operations, liquidity, and capital resources.

³ See Regulation S-K, Item 303(a)(4)(ii), for the definition of off-balance-sheet entities for these purposes.

SEC Issues Letter Clarifying Accounting Ramifications of Accelerated Efforts to Mitigate Subprime Crisis

SEC Chief Accountant Conrad Hewitt issued a [letter](#) addressing the Statement 140 accounting implications of the American Securitization Forum's [Streamlined Foreclosure and Loss Avoidance Framework](#) ("ASF Framework").⁴ The ASF, coordinating with the Department of the Treasury, developed the Framework to encourage mortgage loan servicers to refinance or modify classes of adjustable-rate subprime mortgage loans with certain risk characteristics that make them susceptible to default. However, a potential hurdle has been whether the modifications of mortgage loans violate qualifying special-purpose entity (QSPE) status under Statement 140.

The SEC's letter, addressed to both the Financial Executive International's Committee on Corporate Reporting and the Center for Audit Quality's Professional Practice Executive Committee, indicates that the Office of the Chief Accountant (OCA) "will not object to continued status as a QSPE if Segment 2 subprime ARM loans are modified pursuant to the specific screening criteria in the ASF Framework." The letter also states that the "OCA believes that it would be reasonable to conclude that Segment 2 subprime ARM loans are 'reasonably foreseeable' of default in absence of a modification based upon a qualitative consideration of the expectation of defaults."⁵ Appendix A of the letter sets forth disclosures that the SEC staff generally expects will be included in registrants' MD&A and notes to the financial statements.

Other Deloitte & Touche LLP Resources

- [Financial Reporting Alert 07-4, "Key Accounting Issues and the Current Credit Environment."](#)
- [Financial Reporting Alert 07-5, "CAQ Update — Key Accounting Issues and the Credit Environment: Center for Audit Quality Issues Final White Papers."](#)
- [Financial Reporting Alert 08-1, "SEC Issues Letter Clarifying Accounting Ramifications of Accelerated Efforts to Mitigate Subprime Crisis."](#)
- [Financial Reporting Alert 08-4, "Turmoil in the Credit Markets: The Importance of Comprehensive and Informative Disclosures."](#)
- [August 29, 2007, Heads Up, "Accounting Consequences of Subprime Loan Modifications."](#)

⁴ "Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans."

⁵ The letter describes limitations on the availability of representative quantitative data for these types of loans.

Financial Instruments

Examples of SEC Comments

- *Hedge Accounting* — Please address the following with respect to these hedges:
 - Tell us all of the terms in the hedged item and the hedging instrument which were not exact mirrors of each other, whether defined as critical or not; and
 - With respect to cash flow hedges . . . tell us how you performed and documented an assessment of hedge effectiveness at inception of the hedging relationship and on an ongoing basis.
- *Embedded Derivatives* — Explain to us how you have considered the guidance in SFAS 133 and EITF 00-19 in determining that you are not required to bifurcate the conversion feature from the host instrument and account for it as a derivative.
- *Financial Asset Transfers* — Please specifically address how you determined the transfer of the receivables to both the third-party qualifying special purpose entity and to the third-party banking institutions met the sales criteria of paragraph 9 of SFAS 140.

Hedge Accounting

Although hedge accounting under Statement 133 has been around for several years, in late 2006 and 2007, the SEC staff made several announcements regarding its application. The announcements were followed by some restatements and many SEC staff comments on the application of Statement 133.

At the 2006 AICPA Conference, Mr. Timothy Kviz, a professional accounting fellow in the SEC's Office of the Chief Accountant, discussed the following issues related to the misapplication of hedge accounting under Statement 133:

- *The Shortcut Method* — Registrants have concluded that their hedging relationships qualify for the shortcut method without meeting all the criteria listed in Statement 133.
- *The Critical-Terms-Match Method and Methods Based on Statement 133 Derivative Implementation Group (DIG) Issue G7* — Without performing analyses, registrants have inappropriately assumed no ineffectiveness in hedging relationships designated under a critical-terms-match method or one of the methods in DIG Issue G7 despite known sources of ineffectiveness.

Mr. Kviz indicated that when a company inappropriately applies the shortcut method or otherwise ignores known sources of hedge ineffectiveness in performing hedge effectiveness assessments, the SEC staff generally believes an error exists for the entire change in fair value of the derivative as if hedge accounting had not been applied. Specifically, Mr. Kviz highlighted several scenarios in which registrants had concluded that a hedging relationship was perfectly matched when known sources of ineffectiveness existed that should have been measured.

At the March 2007 EITF meeting, Mr. Joseph McGrath, another professional accounting fellow in the SEC's Office of the Chief Accountant, revisited several of the hedge accounting issues initially discussed by Mr. Kviz. In that meeting, Mr. McGrath clarified that it was the SEC staff's position that it may be acceptable for a registrant to continue to use the critical-terms-match method even if a known source of ineffectiveness exists provided that the registrant (1) evaluates and supports the reasonableness of the conclusion that the terms match and (2) makes a quantitative assessment to confirm that the hedging relationship is, in fact, highly effective and that any ineffectiveness is de minimis. Mr. McGrath suggested that one example of this might be a hedge of a forecasted foreign currency denominated transaction if the settlement dates of the hedging instrument and the forecasted transaction occur within the same month.

In the wake of these announcements, the SEC staff has issued a significant number of comments requesting registrants to provide detailed information and disclosures related to their hedging relationships. The SEC staff has frequently challenged a registrant's determination that the instrument qualifies for the shortcut or the critical-terms-match methods of accounting. For example, registrants are often asked to provide or disclose some or all of the following:

- How the registrant determined that it met the criteria of paragraph 65 of Statement 133 to qualify for the critical-terms-match method of assessing hedge effectiveness.
- How the registrant determined that it met the criteria of paragraph 68 of Statement 133 to qualify for the shortcut method of assessing hedge effectiveness.
- The nature and terms of the hedged item (including conversion, call, or option features) and the hedging instrument and whether such terms are exact mirrors of each other.
- The specific risk being hedged.
- How effectiveness is assessed at inception and on an ongoing basis for each type of hedge, including the specific quantitative methods used.

- How differences between estimated and actual results have affected hedging relationships (i.e., in determining whether hedge accounting should be discontinued).
- If effectiveness tests failed, what additional procedures the company performed to conclude that it was appropriate to continue applying hedge accounting.

In addition, the SEC staff has challenged the consistency with which measures of assessing hedge effectiveness have been applied.

During 2007, the FASB added to its agenda a project to simplify hedge accounting under Statement 133. The project proposes eliminating the shortcut method, the critical-terms-match method, and the requirement to continually assess hedge effectiveness to qualify for hedge accounting. While any final guidance may provide companies with relief from performing detailed quantitative analyses to support conclusions on hedge accounting, it could be a year or more before such guidance is issued. An exposure draft on this project is expected in the near term. In addition, in January 2008, the FASB issued Implementation Issue E23, which clarifies application of the shortcut method.

Derivatives Embedded in Convertible Debt

As registrants have issued more convertible securities, the SEC staff has issued more comments on such securities. Accounting for convertible securities is a complex area requiring analysis of a security's various features under numerous accounting pronouncements. The SEC's *Current Accounting and Disclosure Issues in the Division of Corporation Finance* (as updated November 30, 2006) (the "report") summarizes some of the accounting considerations:

Embedded conversion features that meet the criteria for bifurcation under SFAS 133 may qualify for the paragraph 11(a) scope exception in SFAS 133. In analyzing whether the conversion feature meets the paragraph 11(a) scope exception, one of the things the registrant must determine is whether the conversion feature would be classified within stockholders' equity. To determine classification, the conversion feature must be analyzed under EITF 00-19. The first step of the EITF 00-19 analysis for these features is to determine whether the host contract is a conventional convertible instrument (paragraph 4 of EITF 00-19 and EITF 05-2, *The Meaning of "Conventional Convertible Debt Instrument" in EITF Issue 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock"*). One of the common features that prevents the convertible instrument from qualifying as "conventional" is a reset provision in the instrument where, if a company issues an instrument in the future that has a price less than the conversion price in the convertible instrument, the conversion price in the convertible instrument is reset. If the instrument is a conventional convertible instrument, the embedded conversion option would qualify for equity classification under *EITF 00-19*, qualify for the

scope exception in SFAS 133 and not be bifurcated from the host instrument. In that case, the convertible instrument should be accounted for in accordance with APB 14; ASR 268 and EITF Topic D-98 should be considered for the classification and measurement of the instrument; and EITFs 98-5 and 00-27 should be considered for any beneficial conversion feature.

If the instrument does not qualify as a conventional convertible, paragraphs 7–32 of EITF 00-19 must be analyzed to determine whether the conversion feature should be accounted for as a liability or equity. If the feature is classified as a liability under EITF 00-19, it would not qualify for the paragraph 11 scope exception in SFAS 133 and therefore the feature would be accounted for as a derivative at fair value, with changes in fair value recorded in earnings. If the feature is classified as equity under EITF 00-19 and meets the other criterion in the SFAS 133 paragraph 11 scope exception, the embedded conversion option is not bifurcated from the host instrument. The registrant should assess whether the convertible preferred stock instrument should be classified in permanent equity or temporary equity by reference to ASR 268 and EITF D-98. Additionally, registrants should assess whether there is a beneficial conversion feature that must be accounted for under EITFs 98-5 and 00-27.

The report identified convertible securities that require the issuance of an unlimited variable number of shares as one cause of improper accounting. The issuer of such securities usually is required to bifurcate the conversion option because the issuer is unable to exclude itself from the scope of Statement 133.⁶

At the 2006 AICPA Conference, Ms. Stephanie Hunsaker, associate chief accountant in the SEC's Division of Corporation Finance, stated that the SEC staff will continue to focus on the classification of convertible instruments and the registrant's accounting treatment for such instruments.

The SEC staff frequently asks questions about the accounting, nature, and terms of convertible instruments. For example, the staff often requests that registrants that have issued convertible debt, but have not accounted for the conversion feature or other features as derivatives separate from the debt, either disclose or provide information regarding the following:

- Whether the registrant has considered whether the convertible debt includes an embedded derivative.
- Whether the convertible debt qualifies as conventional convertible debt under Issue 05-2.

⁶ Because the conversion option requires the issuance of an unlimited number of shares, it is possible that the issuer would be forced to cash-settle the conversion option because the number of shares into which the security is potentially convertible exceeds the number of currently authorized but unissued shares. Since the issuer could be forced to settle the conversion option in cash rather than shares, the conversion option would not qualify for the scope exception in Statement 133 for items classified in equity.

The SEC staff has requested that registrants that have disclosed that they have an embedded derivative, but that did not record the bifurcated amount because of immateriality, provide the assumptions used to value the instrument and how they concluded that the amount was immaterial.

A number of comments have also been issued about convertible preferred stock. The SEC staff has asked registrants whether they have evaluated their convertible preferred stock under Issue 00-19. Registrants have also been asked to perform additional analysis or provide additional information (such as the actual agreement). This request is common when some or all of the preferred stock is not convertible into a fixed number of shares or contains a reset provision.

Financial Asset Transfers

The SEC staff often requests that registrants that transfer financial assets to a special-purpose entity and account for the transaction as a sale provide additional information to support sale accounting. For example, registrants that have continuing involvement with the transferred assets or the special-purpose entity may be asked to provide evidence (such as a legal opinion) to support the assertion that the transferred assets are legally isolated.

In addition, the SEC staff may request that registrants provide additional information in their accounting-policy footnote, such as the nature and terms of asset transfers and how the accounting treatment complies with Statement 140. The SEC staff has challenged registrants that account for a transfer as a sale when they have historically accounted for similar transfers as secured borrowings.

Other Deloitte & Touche LLP Resources

- January 18, 2007, *Heads Up*, "Matching Critical Terms in Hedge Strategies."
- March 19, 2007, *Heads Up*, "Using the Critical-Terms-Match Method for Evaluating Hedges."
- January 14, 2008, *Heads Up*, "FASB Clarifies Application of the Shortcut Method."

Financial Statement Classification — Income Statement and Statement of Cash Flows

Examples of SEC Comments

Income Statement Classification

- *Revenue and Cost of Sales* — Please revise your consolidated statements of earnings in future filings to separately present revenue and cost of sales . . . for your product sales and services. You may only aggregate these revenues if both classes of revenue are less than ten percent of total revenues. Refer to Rule 5-03(b) of Regulation S-X.
- *Cost of Sales* — The line item ‘Depreciation and Amortization’ in the income statement appears to include all depreciation and amortization expense. Tell us the amounts of depreciation and amortization included in this amount that relate to products and services provided to customers and why you have not included these amounts in costs of revenue. That is, tell us how you considered the guidance in SAB Topic 11.B.
- *Cost of Sales* — Please . . . tell us whether you include inbound freight charges, purchasing and receiving costs, inspection costs, warehousing costs, internal transfer costs, and the other costs of your distribution network in the cost of goods sold line item. . . . If you currently exclude a portion of these costs from cost of goods sold, please disclose . . . the line items that these excluded costs are included in and the amounts included in each line item, and in MD&A that your gross margins may not be comparable to those of other entities, since some entities include all of the costs related to their distribution network in cost of goods sold and others like you exclude a portion of them from gross margin, including them instead in a line item, such as distribution, selling, or general and administrative expenses.
- *Operating Versus Nonoperating Income* — We note you exclude settlement expense from income from operations. It does not appear that this presentation is appropriate considering the nature of these expenses as disclosed in the notes to your financial statements. Please revise to include these expenses in operations or tell us why a revision is unnecessary.

Statement of Cash Flows Classification

- Please explain to us in greater detail the nature and timing of the insurance reimbursement cash flows for claim payments classified as investing activity.

The SEC staff continues to issue comments on classification in financial statements, particularly on the income statement and the statement of cash flows. Income statement classification comments tend to concentrate on ensuring compliance with both the general requirements and industry-specific requirements of Regulation S-X, and on analyzing what is included in or excluded from each line item. Although still numerous, comments on the statement of cash flows have decreased as companies have improved their presentation.

Income Statement

There is often no clear guidance on classification of income and expense items. As a result, in many cases, classification has been established through practice and the SEC comment process. The SEC staff has reminded registrants that when alternative classifications are permissible, registrants should disclose their policies and apply them consistently, in accordance with Opinion 22.

Revenue

The SEC staff's comments on revenue have focused on two main areas. The first relates to the components of revenues. The SEC staff may challenge the inclusion of items in revenue that do not directly result from selling a company's products or delivering its services, such as equity in earnings of unconsolidated affiliates or interest income.

The second comment area relates to distinguishing between products and services revenues. If product or service revenues are greater than 10 percent of total revenues, the company is required to disclose this as a separate line item on the face of the income statement.⁷ This same rule applies to product and service costs in the "cost of sales" line item.

Cost of Sales

The SEC staff sometimes challenges companies that omit a "cost of sales" or "cost of revenues" line item, believing that many companies and industries have these types of expenses and should show them separately on the face of the income statement.

⁷ According to Regulation S-X, Rule 5-03(b).

Another common comment on cost of sales relates to allocation of amortization and depreciation to cost of sales. SAB Topic 11.B states, in part:

If cost of sales or operating expenses exclude charges for depreciation, depletion and amortization of property, plant and equipment, the description of the line item should read somewhat as follows: "Cost of goods sold (exclusive of items shown separately below)" or "Cost of goods sold (exclusive of depreciation shown separately below)." . . . depreciation, depletion and amortization should not be positioned in the income statement in a manner which results in reporting a figure for income before depreciation.

Most of the SEC staff's comments in this area have stemmed from companies' lack of awareness or incorrect application of the guidance in SAB Topic 11.B, particularly their inappropriate reporting of an amount for gross profit before depreciation and amortization.

In addition, the SEC staff often asks registrants whether they include distribution costs in costs of sales. Companies may be asked to disclose the line item in which such costs are recorded, and that their cost of sales may not be comparable to that of other registrants.

Gross Profit

Regulation S-X does not require presentation of gross profit on the face of the annual income statement. However, Regulation S-K, Item 302, requires disclosure of gross profit in the selected quarterly data. The staff has issued comments requesting that a company include gross profit in the quarterly presentation, which, in turn, may result in a company's presenting such information on the face of the annual income statement.

Operating Versus Nonoperating Income

Comments in this area primarily concern what should be included in or excluded from operating income (if a subtotal for operating income is presented, which is not required). Items that should generally be **included** in operating income (but that are sometimes incorrectly excluded) are:

- Gains or losses on asset sales.
- Litigation settlements.
- Insurance proceeds.
- Restructuring charges.
- Recapitalization expenses (legal fees, due diligence expenses, etc.).

Items that should generally be **excluded** from operating income (but that are sometimes

incorrectly included) are:

- Dividends.
- Interest on securities.
- Profits on securities (net of losses).
- Interest and amortization of debt discount and expense.
- Earnings from equity method investments (or unconsolidated affiliates).
- Minority interest in income of consolidated subsidiaries.

Statement of Cash Flows

Many of the SEC staff's cash flow comments relate to misclassification among the three cash flow categories: operating, investing, and financing. A recurring comment pertains to changes in restricted cash. See Deloitte & Touche LLP's *Heads Up* on the 2006 AICPA Conference for a summary of a speech by Ms. Carol Stacey, chief accountant in the SEC's Division of Corporation Finance, on the SEC staff position on changes in restricted cash. The SEC staff also frequently comments on the classification of insurance proceeds, which should be classified according to what the insurance was covering, not what the proceeds are used for (i.e., property-damage proceeds would be "investing" and business interruption proceeds would be "operating").

Another common topic of SEC comment is the presentation in the cash flow statement of discontinued operations. Registrants are not required to present cash flows related to discontinued operations separately from cash flows related to continuing operations. Cash flows related to discontinued operations that a registrant chooses to present separately must be reported as "operating," "investing," or "financing." See Deloitte & Touche LLP's *Heads Up* on the 2005 AICPA Conference for a summary of a speech by Mr. Joel Levine, associate chief accountant in the SEC's Division of Corporation Finance, regarding appropriate presentation alternatives. See also AICPA CPCAF Alert #98, Update to the SEC Staff Position Regarding Changes to the Statement of Cash Flows Relating to Discontinued Operations (Addendum to CPCAF Alert #90).

Management’s Discussion and Analysis

Examples of SEC Comments

- *Results of Operations* — Please revise your disclosure to quantify the various reasons given for changes in your revenue and expense line items.
- *Results of Operations* — Please revise the discussion of your results of operations to indicate whether the changes represent trends expected to continue into the future. Also discuss any other known trends, demands, commitments, events or uncertainties that will, or are reasonably likely to have a material effect on financial condition and/or operating performance.
- *Contractual Obligations* — Please revise the table of contractual obligations to include estimated interest payments on your debt and post retirement benefit payments. Because the table is aimed at increasing transparency of cash flow, we believe these payments should be included in the table. Please also disclose any assumptions you made to derive these amounts.
- *Critical Accounting Policies* — We see no discussion of any specific judgments or uncertainties associated with your critical accounting policies that would assist readers in assessing the predictive value of your reported financial information.

See the [Fair Value and the Turmoil in the Credit Markets](#) section for information about a sample letter the SEC staff recently sent to several registrants that have exposure to off-balance-sheet entities. The letter includes disclosures that such registrants may want to consider in preparing their MD&A.

Results of Operations

In the “results of operations” section of MD&A, the SEC staff frequently comments on improving the discussion and analysis of known trends, demands, commitments, events, and uncertainties, as well as on providing better forward-looking information. This discussion and analysis is crucial to understanding the quality of, and potential variability in, a company’s earnings and cash flows, as well as the extent to which reported results

are indicative of future performance. A determination of whether such disclosure is required generally should include:

- Consideration of financial, operational, and other information.
- Identification of known trends and uncertainties.
- Assessment of whether these trends and uncertainties will have, or are reasonably likely to have, a material impact on the company's financial condition and operating performance.

Quantitative disclosure of the effects of known trends and uncertainties should be considered if such information is material and reasonably available.

In addition, many comments that the SEC staff has issued regarding the results of operations section of MD&A deal with quantitative analyses. The SEC staff expects registrants to quantify, in their narrative explanations, specific reasons for the fluctuations for year-to-year or period-to-period changes, particularly when multiple factors are contributing to such changes.

Liquidity and Capital Resources

The SEC staff has commented that registrants often have not included insightful, forward-looking disclosure in MD&A. The comments frequently request registrants to provide more meaningful analysis of historical sources and uses of cash. In addition, registrants must disclose significant developments in liquidity or capital resources that occur after the balance sheet date.

Contractual Obligations

The SEC staff continues to issue comments relating to the contractual obligations table and associated notes and disclosures. Such comments typically focus on (1) a registrant's omission of material obligations, such as interest payments on debt, pension obligations, and uncertain tax position liabilities, and (2) omission of disclosure of the terms of obligations, such as purchase obligations. (See the [Uncertain Tax Positions](#) section for more information about Interpretation 48 liabilities and the contractual obligations table.) To the extent the obligations cannot be quantified, the SEC staff expects companies to disclose information necessary for investors and users to understand the nature and extent of the registrant's obligations.

Critical Accounting Policies

This section of MD&A should focus only on those financial statement items that require significant management estimates and judgment. Companies should not simply copy their accounting policy disclosure from the footnotes to the financial statements. Instead, the SEC staff expects discussion and analysis of material uncertainties associated with the methods and assumptions underlying each critical accounting estimate.

Registrants should include an analysis of the sensitivity of estimates to change on the basis of outcomes that are reasonably likely to occur and that would have a material effect. The sensitivity analysis should be quantitative if such information is reasonably available.

Supplemental MD&A Based on Pro Forma Financial Information

While supplemental disclosures based on pro forma financial information are not required, at the 2007 AICPA Conference, Mr. Steven Jacobs, associate chief accountant in the SEC's Division of Corporation Finance, stated that supplemental MD&A may more relevantly and fully address trends and changes in registrants' results of operations.⁸ He indicated that supplemental MD&A disclosures based on pro forma financial information may be meaningful in the following circumstances:

- When a registrant acquires a large business.
- When a change in a registrant's basis because of push-down accounting results in the presentation of predecessor and successor results.
- When a newly formed entity acquires an operating company in a leveraged buyout transaction.

Mr. Jacobs indicated that in determining whether to include supplemental pro forma MD&A, registrants should consider all the facts and circumstances surrounding the transaction, the nature of pro forma adjustments, and the overall relevance of the supplemental discussion. For additional information about Mr. Jacobs's remarks, see Deloitte & Touche LLP's *Heads Up* on the 2007 AICPA Conference. See also [SEC Interpretive Release, Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations](#).

⁸ The supplemental MD&A presentation is in addition to, and not in lieu of, the historical MD&A discussion.

Revenue Recognition

Examples of SEC Comments

- *Multiple-Element Arrangements* — Tell us how your separation of the installation services as a separate unit of accounting complies with EITF 00-21. As part of your response, clarify how you have determined there is objective and reliable evidence of fair value of the hardware installation services; we refer you to paragraph 9 of EITF 00-21. Further explain the basis for your revenue and expense recognition and timing for installation services.
- *Software Revenue Recognition* — We note your disclosures . . . and your reference to EITF 03-5. Do the Company's products include software that is more than incidental . . .? If so, please explain how your accounting for such product sales complies with EITF 03-5 and SOP 97-2. If not, then please explain the reference to this guidance in your disclosures.
- *Gift Card Revenue* — In future filings please provide more detailed disclosures regarding your accounting policies for estimating, recognizing and classifying gift card breakage. Also, to the extent that breakage is a material source of income please disclose the amount of breakage for each year presented.

Multiple-Element Arrangements

The SEC staff often asks about the nature of, and accounting for, the registrant's multiple-element arrangements and whether the registrant evaluated these arrangements under Issue 00-21. The staff typically requests more extensive disclosures, and sometimes supplemental information, for multiple-element arrangements, including the following:

- The nature of the elements involved.
- The registrant's accounting policy for each element, including how revenue is allocated to it.
- The registrant's method for determining whether certain deliverables in an arrangement qualify as separate units of accounting.
- The registrant's support for its conclusion that the delivered item has stand-alone value.
- The timing of revenue recognition for each element.

At the 2007 AICPA Conference, Mr. Mark Barrysmith, a professional accounting fellow in the SEC's Office of the Chief Accountant, discussed deliverables in the context of collaborative research and development arrangements. (For additional information, see Deloitte & Touche LLP's *Heads Up* on the 2007 AICPA Conference.) The issues surrounding these types of arrangements may apply to other revenue arrangements. For example, Mr. Barrysmith noted that while the term "deliverable" is not defined in the accounting literature, "some have considered a deliverable to be an item that 1) is explicitly referred to as an obligation of the vendor in a contractual arrangement, 2) requires a distinct action by the vendor, 3) if not completed by the vendor would result in a significant contractual penalty, or 4) if included or excluded from the arrangement would cause the arrangement fee to vary by more than an insignificant amount."

Mr. Barrysmith said that when evaluating whether a vendor's obligations under an arrangement rise "to the level of a deliverable," entities should focus on their obligations under the arrangements and use the above criteria as a starting point. Collectively, these criteria, along with his remarks and the discussion of inconsequential or perfunctory deliverables in SAB 104, constitute a general principle that should be applied in these arrangements.

Software Revenue Recognition

SOP 97-2 provides guidance on when and how entities should recognize revenue for software transactions. The SEC staff has increased its scrutiny in this area because it has recently seen a trend in which companies that are not considered to be traditional software companies should be recognizing revenue under SOP 97-2 but are not. That is, these companies are selling products that include software that is more than incidental to the arrangement, so the software-related elements are within the scope of SOP 97-2. The SEC staff has focused on identifying situations in which these registrants should recognize revenue in accordance with the SOP. If information in a registrant's filing indicates that the registrant's products or services include software, the staff asks the registrant to clarify whether the software is "more than incidental" and how the registrant is recognizing revenue for the deliverables. The staff has also requested registrants to discuss Issue 03-5's applicability to their arrangements. (Issue 03-5 clarifies which elements in an arrangement are within the scope of SOP 97-2.)

At the 2007 AICPA Conference, Ms. Sandie Kim, a professional accounting fellow in the SEC's Office of the Chief Accountant, discussed revenue recognition for hardware deliverables in software arrangements. She pointed out that as a result of "exponential advances in technology . . . more and more hardware deliverables" are being included in the scope of SOP 97-2. Applying SOP 97-2 to multiple units of hardware delivered

over a long period can be difficult, especially when “vendor-specific objective evidence (VSOE) of fair value does not exist for such hardware.” Ms. Kim noted that SOP 97-2 appears to require deferral of all revenue in such arrangements until VSOE is established or all hardware elements are delivered. However, she explained that SOP 97-2 “does contain exceptions to the general rule on revenue deferral,” specifically when the only undelivered elements are postcontract customer support (PCS) or certain services. This would allow for proportional recognition of revenue for multiple units of hardware delivered over a period in which VSOE of fair value does not exist for the hardware. Such accounting would be similar to ratable recognition of a fee over a PCS period or over a period during which services are expected to be performed.

Ms. Kim also emphasized that when the only undelivered elements in a software arrangement are PCS and services, in practice, recognition of the entire fee is allowed over the longer of the PCS or service period. She noted that the basis for this view is that there is “no inappropriate front-loading of revenue since revenue, including any significant discount that may be included in the arrangement, is recognized over the longest period of performance.”

By analogy to PCS and services under SOP 97-2, Ms. Kim believes that a “reasonable application of the provisions of SOP 97-2 can result in proportionate recognition of revenue for hardware without VSOE of fair value if the remaining deliverables are multiple units of the same product.” She used the following example to illustrate her point:

[A] company has an arrangement in which the remaining deliverables are 100 units of Hardware Product A and 200 units of Hardware Product B. VSOE of fair value does not exist for either hardware product and both hardware products are in the scope of SOP 97-2. In this fact pattern, the staff would not object if revenue were recognized based on a consistent ratio of both products (that is, one unit of Product A for every two units of Product B).⁶ This methodology ensures that revenue is not prematurely recognized and that any discount in the arrangement is recognized proportionately.

⁶ Continuing on with the example, if four units of Product A were delivered at \$10 per unit and four units of Product B were delivered at \$15 per unit in a particular period, revenue would be limited to two units of Product A (\$20) and four units of product B (\$60). If instead, two units of Product A were delivered and six units of Product B were delivered, revenue would likewise be limited to two units of Product A (\$20) and four units of Product B (\$60).

Gift Card Revenue

The reporting of gift card revenue is another area of SEC staff focus, probably because of the subjectivity of estimating gift card breakage (the amount that is never redeemed). At the 2005 AICPA Conference, Ms. Pamela Schlosser, a professional accounting fellow in the SEC’s Office of the Chief Accountant, mentioned that the SEC staff’s primary concern about breakage is that companies inappropriately recognize breakage as revenue at the time payment is received. The SEC staff has requested additional disclosures

or explanations of the registrant's process for estimating breakage and its policy for recognizing breakage (i.e., upon sale of gift cards or over the performance period). In certain instances, the SEC staff has also requested supporting documentation such as:

- Historical information supporting the estimate of breakage and whether it is based on a large pool of homogeneous transactions.
- The estimated gift card breakage rate.

The SEC staff may also request information about the nature of the registrant's gift card arrangements — for example, whether the registrant's cards are redeemable for cash or carry expiration dates.

Product and Service Revenue Presentation

Also at the 2007 AICPA Conference, Mr. Barrysmith discussed financial statement presentation of product and service revenue. SEC Regulation S-X, Rule 5-03(b), requires that product revenue and service revenue, along with other categories of revenue, be displayed separately in the income statement if they are greater than 10 percent of total revenues. (See the [Financial Statement Classification — Income Statement and Statement of Cash Flows](#) section for additional information.) As noted by Mr. Barrysmith, a frequent question is how a vendor can adhere to this requirement when it is unable to separate its multiple-element arrangements under applicable revenue recognition guidance, such as Issue 00-21 or SOP 97-2.

Mr. Barrysmith indicated that because investors find the disaggregation of this information useful, the staff does not believe that the inability to separate deliverables for recognition purposes necessarily precludes separate display of product and service revenue. As long as there is a reasonable basis for the separation method and it is consistently applied, clearly disclosed, and not misleading, the SEC would not, according to Mr. Barrysmith, object to the separate presentation of product and service revenue. For example, for transactions within the scope of SOP 97-2, a comparison to third-party evidence of fair value for similar products or services may be appropriate. Likewise, the use of the residual method when a vendor customizes its products may also be appropriate. However, he cautioned that a systemic allocation that is based solely on consistency or on contractually stated amounts would not be acceptable. He further noted that this view is not limited to product and service revenue and would apply to other revenue categories.

Other Deloitte & Touche LLP Resources

- [Software Revenue Recognition: A Roadmap to Applying AICPA Statement of Position 97-2.](#)

SAB 74 — Disclosures on the Impact of Recently Issued Accounting Pronouncements

Examples of SEC Comments

- Please include disclosure in management's discussion and analysis regarding the impact that recently issued accounting standards will have on the financial statements when adopted. Refer to the requirements of SAB Topic 11:M.
- Please provide to us your evaluation of the impact of adopting FIN 48. Furthermore, please explain why there appears to be no disclosure regarding the impact that FIN 48 will have on your financial statements, in particular when the Interpretation was issued in June of 2006. See SAB Topic 11:M.

SAB Topic 11.M (SAB 74) requires disclosures about the effects of recently issued accounting standards that are not yet effective. The disclosures are required for new FASB Statements and Interpretations, FSPs, EITF consensuses, AICPA SOPs, and SEC SABs. For example, calendar-year-end registrants should include SAB 74 disclosures for FASB Statements 141(R), 157, 159, and 160 in their 2007 Forms 10-K. See Deloitte & Touche LLP's [Accounting Roundup Year in Review — 2007](#) for summaries of these Statements and other guidance issued during the year.

The disclosures should assist financial statement users in assessing the impact the new standard will have once adopted. According to SAB 74, a registrant should consider the following disclosures:

- A brief description of the new standard, the date that adoption is required and the date that the registrant plans to adopt, if earlier.
- A discussion of the methods of adoption allowed by the standard and the method expected to be utilized by the registrant, if determined.
- A discussion of the impact that adoption of the standard is expected to have on the financial statements of the registrant, unless not known or reasonably estimable. In that case, a statement to that effect may be made.

SEC Comment Letters on Domestic Registrants

A Closer Look

- Disclosure of the potential impact of other significant matters that the registrant believes might result from the adoption of the standard (such as technical violations of debt covenant agreements, planned or intended changes in business practices, etc.) is encouraged.

A registrant should disclose this information in both MD&A and in the footnotes to the financial statements.

The SEC staff sometimes issues comments if the disclosures do not meet the above requirements. It may also review information outside of the financial statements for indicators that a new accounting pronouncement affects a registrant, and will expect adequate disclosures.

The SEC staff also expects a registrant to disclose more specific details in filings as the effective date of a new standard approaches. For example, Statement 159 was issued in February 2007 with an effective date as of the beginning of a reporting entity's first fiscal year beginning after November 15, 2007. A calendar-year-end registrant may not have been able to reasonably estimate whether Statement 159's impact on its financial statements would be material with respect to SAB 74 disclosures in its March 31, 2007, Form 10-Q. The registrant will adopt Statement 159 on January 1, 2008, and will be issuing its December 31, 2007, Form 10-K after that date. Therefore, the registrant should be able to disclose specifics in its December 31, 2007, Form 10-K (e.g., the instruments for which it will elect the fair value option, if any, and the amount of the cumulative-effect adjustment, if any).

SEC Reporting (Regulation S-X Misapplication)

Examples of SEC Comments

- *Significant Business Acquisitions* — It appears that you may have an acquisition that is currently deemed probable and that would be significant at greater than 50% based on pre-tax income. If our understanding is correct, please revise to provide the information required by Rules 3-05 and 11-01 of Regulation S-X concerning this probable acquisition. Otherwise, please explain to us why you do not believe that this information is required.
- *Investments in Equity Method Investees* — We note that you include in your Form 10-K for the year ended December 31, 2006 the financial statements of Equity Method Investee [X] for 2005 and 2004 under Rule 3-09 of Regulation S-X. We also note that you began consolidating [X] in June of 2006 and classified the investment as a discontinued operation in November 2006. Please explain your basis for not including the financial statements of [X] for 2006 up to the date of consolidation in your filing. See Rule 3-09(b) of Regulation S-X. Please also advise as to why you have not filed pro forma financial statements disclosing the effect of the divestiture under Article 11 of Regulation S-X.

The SEC staff often comments on form and content issues in the separate financial statements of other entities or pro forma information that registrants must provide under Regulation S-X.

Significant Business Acquisitions (Rule 3-05)

When a registrant consummates, or it is probable that it will consummate, a significant business acquisition, the SEC staff may require the filing of certain financial statements for the acquired or to be acquired business (acquiree) under Regulation S-X, Rule 3-05. The number of financial statement periods of the acquiree that a registrant is required to present primarily depends on the significance of the acquiree to the registrant. The significance is calculated on the basis of three tests: the investment (purchase price) test, the asset test, and the income test. The following factors govern whether, and for what period, financial statements for the acquiree are required:

- Whether the acquired or to be acquired assets and liabilities meet the definition of a business.

- Significance of the acquired or to be acquired business.
- Whether consummation of the business acquisition is probable or has recently occurred.

Registrants may not file the appropriate financial statements because they:

- Do not perform the significance calculations correctly. Some of the most common mistakes are misapplications of the income test, such as using income averaging in the year of a loss or excluding unusual gains or losses from the test.
- Incorrectly determine that the acquired or to be acquired assets and liabilities do not meet the definition of a business for SEC reporting purposes. The definition of a business for SEC reporting purposes under Regulation S-X, Article 11, is not the same as the definition under Issue 98-3 for U.S. GAAP purposes.
- Do not realize that Rule 3-05 also applies in a registration statement to probable acquisitions whose significance is greater than 50 percent.
- Do not consider in a registration statement the cumulative significance of previously consummated individually insignificant acquisitions.

Investments in Equity Method Investees (Rule 3-09)

When a registrant has a significant equity method investment, the SEC requires the filing of certain financial statements for the investee under Regulation S-X, Rule 3-09. Significance is calculated for equity method investees on the basis of two tests: the investment test and the income test. This rule is of particular importance since the separate financial statements are required in Form 10-K; therefore, failure to file them may cause a registrant to become a delinquent filer and lose Form S-3 eligibility.

Registrants may make mistakes related to the Rule 3-09 significance tests, such as:

- Not updating or documenting the tests each year. This is most common when an equity investee has been clearly insignificant in the past. However, in unusual situations, such as a near break-even year for the registrant or a large gain or loss at the investee level, the current year's significance is dramatically changed, making the equity investee significant for the first time. In addition, the significance tests should be updated and reassessed for all years presented in a Form 10-K after a registrant reports discontinued operations.
- Not including a gain or loss on disposal of an equity method investee (or an impairment) in the annual significance calculation. The gain or loss frequently will cause the registrant to perform the significance test. Even if the investee is completely disposed of during the year, the registrant still needs to perform the test to determine whether financial statements are required.

Guarantors of Registered Securities (Rule 3-10) and Issuers of Securities That Collateralize Registered Securities (Rule 3-16)

Registrants often look at Regulation S-X, Rules 3-10 and 3-16, as one test or as related tests, but should be aware that the tests in Rule 3-10 and Rule 3-16 are separate and distinct and must be assessed individually. Rule 3-10 may require a company to provide separate financial statements or condensed consolidating financial information for guarantors of registered debt. A common error is for the registrant to incorrectly assume that certain exceptions in the rule are met, and therefore to conclude that it does not have to provide separate financial statements or condensed consolidating financial information. In addition, registrants may incorrectly prepare required condensed consolidating financial information by, for example, not presenting subsidiaries under the equity method in the separate columns in the condensed consolidating information. Similar issues may occur related to compliance with Rule 3-16, which may require financial statements of a parent company's affiliate that collateralizes its public debt. Rule 3-16 does not have an exception that allows for condensed consolidating financial information in lieu of full financial statements. Both rules include specific tests and "bright-line" requirements.

Pro Forma Financial Information (Article 11)

Registrants must often provide pro forma information for significant transactions, such as a business combination or disposition. Article 11 of Regulation S-X requires that pro forma adjustments be "(i) directly attributable to the transaction, (ii) expected to have a continuing impact on the registrant, and (iii) factually supportable." The SEC staff has issued comments to registrants for failing to clearly explain each financial statement adjustment or not clearly indicating how the requirements above are met.

Other Deloitte & Touche LLP Resources

Deloitte & Touche LLP recently issued an SEC reporting interpretations manual that includes Q&As and interpretive guidance on Regulation S-X issues. The manual is available on Technical Library: The Deloitte Accounting Research Tool. See [Appendix D](#) for further details.

Segment Reporting

Examples of SEC Comments

- *Identification and Aggregation of Operating Segments* — We note that you have one reportable operating segment. It appears from your disclosures elsewhere in the filing . . . that you may have aggregated multiple operating segments into one reportable segment. Please provide us with a detailed explanation of how you determined both your operating segments and your reportable segment.
- *Aggregation of Operating Segments* — Please provide us with net revenue and net segment margins, along with any other information you believe would be useful . . . for each of the five years . . . to help us understand how the aggregated operating segments are economically similar.
- *Changes in Reportable Segments* — We note that you changed the composition of your reportable segments. . . . Please tell us the changes in the structure of your organization that caused the composition of your reportable segments to change. . . . In addition, if segment information for earlier periods is not restated please disclose segment information for the current periods under both the old basis and the new basis of segmentation unless it is impracticable to do so. Please refer to paragraphs 33–35 of SFAS 131.

Identification of Operating Segments

Much of the SEC staff's focus in this area is on what financial information the chief operating decision maker (CODM) receives and reviews. The SEC frequently asks registrants to explain in detail how operating segments were determined and what information the CODM receives and reviews.

When a CODM regularly receives a component's discrete financial information, this may indicate that the component is an operating segment. The SEC staff may request the financial information reviewed by the CODM. In addition, the SEC staff may review the information in the forepart of the Form 10-K, such as the business section and MD&A, and information from public sources, such as the company's Web site, analysts' reports, and press releases, for consistency with a company's segment disclosures.

Aggregation of Operating Segments

Statement 131 permits a company to aggregate operating segments if the aggregation is “consistent with the objective and basic principles [of Statement 131 and] if the segments have similar economic characteristics.” The Statement also notes that the segments must be similar in each of the following areas:

- a. The nature of the products and services
- b. The nature of the production processes
- c. The type or class of customer for their products and services
- d. The methods used to distribute their products or provide their services
- e. If applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities.

The SEC staff has indicated that it views aggregation as a “high hurdle.” Companies should maintain detailed analyses of their operating segments and consideration of the aggregation criteria. In evaluating aggregation of operating segments, the SEC staff believes that investors are interested in reviewing the same information that the company’s management reviews.

Paragraphs 18–24 of Statement 131 provide quantitative thresholds and guidance that a company should use to evaluate which operating segments it should report separately. One area that the SEC continues to comment on is quantitatively immaterial segments. Companies may believe they can aggregate such segments with a reportable segment because they do not meet the threshold for separate presentation. However, quantitatively immaterial segments should not be aggregated with reportable segments unless they share all of the aggregation criteria. Otherwise, quantitatively immaterial segments should be classified in the “other” category.

Changes in Reportable Segments

Paragraphs 34–35 of Statement 131 discuss the requirement to recast prior-period information for consistency with current reportable segments. If a company changes the structure of its business after year-end, the new segment structure should not be presented in financial statements until operating results managed on the basis of that structure are reported (typically in a periodic filing such as a Form 10-K or 10-Q). However, disclosure of the future effects of the change may be useful. The SEC’s *Current Accounting and Disclosure Issues in the Division of Corporation Finance* (the “report”) (as updated November 30, 2006) indicates that “[i]f annual financial statements are required in a registration or proxy statement that includes subsequent periods managed

on the basis of the new organizational structure, the annual audited financial statements should include a revised segment footnote that reflects the new reportable segments.” A company can either include the revised (recasted) financial statements in the registration or proxy statement or can recast them in a Form 8-K, which can be incorporated by reference.

Product and Service Revenue by Segment

The report reminds registrants to “remember to identify the products and services from which each reportable segment derives its revenues, and to report the total revenues from external customers for each product or service or each group of similar products and services,” in accordance with paragraph 27 of Statement 131. Regarding the determination of what constitutes “similar” products and services, the SEC “has objected to overly broad views.”

Operating Segments and Goodwill Impairment

Companies should be aware that incorrectly identifying operating segments can have an impact on goodwill impairment testing. Goodwill is tested at the reporting unit level, according to Statement 142, and reporting units are identified as either operating segments or one level below. If a company has not correctly identified its operating segments, it could be testing goodwill at the wrong level.

Share-Based Payments

Examples of SEC Comments

- *Disclosures* — Please disclose information in regard to options expected to vest and fully vested options (to the extent different from options exercisable) pursuant to paragraph A240d of FAS 123R.
- *Valuation Methods and Assumptions* — We note from your disclosure . . . that the estimated fair market value methodology used to value the restricted shares was based on the June X, 20XX transaction, though on a discounted basis. Please explain your valuation methodology, including significant assumptions, to us in detail and why the valuation represents your best estimate of the market value of the stock on the date of issuance of the restricted shares.
- *Financial Statement Presentation of Share-Based Payment Awards* — We note that you present stock-based compensation as a separate component of general and administrative expense. Please modify your presentation to include the expense related to share-based payment arrangements in the same line item or lines as cash compensation paid to the same employees. Refer to Topic 14:F of SAB 107 for further guidance.

The SEC staff frequently comments on the disclosures, valuation methods, accounting, and financial statement presentation associated with share-based payments.

Disclosures

Registrants should ensure that their disclosures address the following objectives outlined in paragraph 64 of Statement 123(R):

- The “nature and terms” of share-based payment arrangements.
- The “effect of [the related] compensation cost . . . on the income statement.”
- The “method [for determining] the fair value of the equity instruments granted.”
- The “cash flow effects [of] share-based payment arrangements.”

The SEC staff has focused its comments on share-based payments disclosures on items such as:

- The nature of and reason for a modification in the stock option award's terms and how the registrant accounted for that modification.
- The terms and conditions of awards, including whether award holders are entitled to dividends or dividend equivalents.
- The number of options that are expected to vest and the assumptions used in developing those expectations.
- The registrant's valuation method, including significant assumptions used.

In its comments about disclosures, the SEC staff frequently cites the guidance in paragraph A240 of Statement 123(R), which describes the "minimum" information needed to achieve paragraph 64's disclosure objectives.

Valuation Methods and Assumptions

The SEC staff frequently asks registrants to disclose more specific information about the valuation methods they use for share-based awards, including significant assumptions. The staff is particularly interested in how registrants determine the expected volatility and the expected term. Assumptions about these matters are subjective and can significantly affect the award's fair value. Sometimes, the staff may question whether the assumptions are based on the best available information. For example, if registrants disclose that they have employee and director options and use the same assumptions to determine the expected life and volatility for both types of options, the staff may question why this is appropriate.

In addition, the SEC staff often asks about the valuation of share-based awards made before a registrant's initial public offering. Examples of common questions are:

- Whether the valuation was a contemporaneous or retrospective valuation of the stock on the issuance date of the award.
- Whether an unrelated valuation specialist did the valuation.
- Whether the registrant used the best practices identified in the AICPA Practice Aid, *Valuation of Privately-Held-Company Equity Securities Issued as Compensation*.

The SEC may also request a copy of the valuation.

At the December 2007 AICPA Conference, Mr. Mark Barrysmith discussed issues entities should consider when using market instruments to measure the fair value of share-based payments. (See Deloitte & Touche LLP's [Heads Up](#) on the 2007 AICPA Conference for additional details on Mr. Barrysmith's remarks.) In addition, Ms. Sandie Kim discussed assumptions that registrants should use in valuing share-based payments. While Statement 157 does not apply to share-based payment arrangements, Ms. Kim noted that Statement 123(R) provides for the use of valuations and assumptions that are consistent with the fair value measurement objective. She explained that when valuing share-based payment arrangements, entities should use assumptions specific to the security rather than assumptions a "specific holder of the security would consider." This concept is similar to Statement 157's concept of the use of market participant assumptions or attributes that would transfer to the market participant. Ms. Kim gave the following examples to illustrate the staff's view on this topic:

Example in which reduction is appropriate — "For example, one common term we see in share-based payment arrangements is a restriction that prohibits the transfer or sale of securities. If the security contains such a restriction that continues after the requisite service period, that post-vesting restriction may be factored as a reduction in the value of the security."

Example in which reduction is not appropriate — "For example, we have heard arguments that a significant discount should be taken on certain share-based payment awards because the securities were issued to a group of executives that were subject to higher taxes than other employees. The staff does not believe this assumption is consistent with a fair value measurement objective."

Ms. Kim reminded companies that if a discount is appropriate, the use of "general rules of thumb" in determining the discount is not appropriate and that the calculation of any discount should be based on information specific to the security.

SEC Staff Issues Guidance on Expected Term

Under Statement 123(R), the term that an option is expected to be outstanding is a key factor in measuring its fair value and the related compensation cost. Question 6 of Section D.2 of [SAB Topic 14](#) sets forth the "simplified" method of estimating the expected term of "plain vanilla" share options, but was due to expire on December 31, 2007. In December 2007, the SEC staff issued [SAB 110](#), which permits entities, under certain circumstances, to continue to use the simplified method. SAB 110 amends and replaces Question 6 of Section D.2 of SAB Topic 14.

There are no hard-and-fast rules in SAB 110's revisions to SAB Topic 14; a company may use the simplified method if it concludes that it is not reasonable to base its estimate of expected term on its historical share option exercise experience. Previously, under SAB Topic 14, a company could avail itself of the simplified method's safe harbor regardless of whether the company had enough information to refine its estimate of expected term.

Financial Statement Presentation of Share-Based Payment Awards

Pursuant to SAB Topic 14.F, share-based compensation expenses should be classified in the same manner as other compensation costs and the presentation should not be driven by the form of consideration paid. Share-based compensation expense should be allocated to cost of sales, research and development, selling and administrative expenses, etc. (as applicable), and should not be separately presented in a single share-based compensation line item. The SEC's *Current Accounting and Disclosure Issues in the Division of Corporation Finance* (as updated November 30, 2006) states:

Registrants should avoid presentations on the face of the financial statements that give the impression that the nature of the expense related to share-based compensation is different from cash compensation paid to the same employees (for example by creating one or more separate line items for share-based compensation or by adding a table totaling the amount of share-based compensation included in various line item[s]).

Other Deloitte & Touche LLP Resources

- [Financial Reporting Alert 07-10, "SEC Extends the Use of the Simplified Method in SAB 107 Under Certain Circumstances."](#)
- [FASB Statement No. 123\(R\), *Share-Based Payment: A Roadmap to Applying the Fair Value Guidance to Share-Based Payment Awards*.](#)

Uncertain Tax Positions

Examples of SEC Comments

- *Disclosures of Unrecognized Tax Benefits* — We note your disclosures regarding . . . various . . . uncertain tax positions related to federal taxes Tell us how you have met each of the disclosure requirements of paragraph 21d of FIN 48 for each significant uncertain tax position.
- *MD&A Considerations* — We note that no disclosure was made regarding material changes in contractual obligations from the amounts that were previously reported in your Form 10-K for the year ended December 31, 2006. Please tell us how you evaluated Instruction 7 to Item 303(b) of Regulation S-K with respect to contractual obligations relating to FIN 48. We note that it does not appear that your prior disclosure of contractual obligations included amounts relating to uncertain tax positions, and we believe that such amounts represent contractual obligations that should be included in the disclosures made under Item 303(a)(5) of Regulation S-K.

Calendar-year-end registrants adopted Interpretation 48 at the beginning of 2007. The Interpretation introduces a new approach that significantly changes how companies recognize and measure tax benefits and disclose income tax uncertainties in their financial statements. Under Interpretation 48, companies cannot recognize a tax benefit related to a tax position unless it is “more likely than not” that tax authorities will sustain the tax position solely on the basis of the position’s technical merits. The tax benefit recognized is measured at the largest amount of the tax benefit that is greater than 50 percent likely to be realized in a negotiated settlement with the taxing authority. Differences between a tax position taken or expected to be taken in a tax return and the benefit recognized and measured pursuant to the Interpretation are referred to as “unrecognized tax benefits.” A liability is recognized (or the amount of net operating loss carryforward or amount refundable is reduced) for the amount of unrecognized tax benefit.

The Interpretation presents numerous accounting and reporting challenges for registrants. For example, financial statements must include disclosures about unrecognized tax benefits (see below for consideration of inclusion of unrecognized tax benefits in the Management’s Discussion and Analysis (MD&A) schedule of contractual

obligations). The application of and disclosures related to Interpretation 48 are expected to be closely scrutinized by the SEC staff and to result in a significant number of SEC staff comments.

Disclosures of Unrecognized Tax Benefits

One of the most controversial aspects of the Interpretation relates to disclosures of a company's unrecognized tax benefits. In particular, paragraph 21(d) of the Interpretation requires that for tax positions "for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date," companies must disclose:

- (1) The nature of the uncertainty
- (2) The nature of the event that could occur in the next 12 months that would cause the change
- (3) An estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made

These disclosures are likely to be an area of focus for the SEC staff. The FASB has not provided further guidance on the acceptable level of aggregation of information. As a result, the SEC staff's expectations for these new disclosures are not yet clear.

Examples of what registrants should disclose pursuant to paragraph 21(d) include the following:

- *Information related to scheduled expiration of the tax position's statute of limitations* — This disclosure should be made if (1) the statute of limitations is scheduled to expire within 12 months of the financial statement's date and (2) management believes that it is reasonably possible that the statute's expiration will cause the total amounts of unrecognized tax benefits to significantly increase or decrease.
- *Significant unrecognized tax benefits for tax positions that the registrant believes will be effectively settled on the basis of the guidance in FSP FIN 48-1.*

The SEC staff may also ask about tax positions disclosed in prior years to verify the registrant's compliance with Interpretation 48. For example, the staff may refer to disclosures in prior filings indicating that the registrant had tax contingency reserves and ask the registrant how it applied Interpretation 48 to those tax contingencies.

Registrants should not forget the other disclosure requirements in Interpretation 48, including:

- “A tabular reconciliation of the total amounts of unrecognized tax benefits.”
- “The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate.”
- “The total amounts of interest and penalties recognized in the statement of operations and . . . the statement of financial position.”
- “A description of tax years that remain subject to examination by major tax jurisdictions.”
- The “policy on classification of interest and penalties.”

MD&A Considerations

Registrants are required to include in the MD&A section a tabular disclosure of all known contractual obligations.⁹ According to discussions at the April 17, 2007, SEC Regulations Committee meeting, a registrant should include the liability for unrecognized tax benefits in the tabular disclosure of contractual obligations in MD&A if it can make reasonably reliable estimates about the liabilities’ period of cash settlement. For example, if any Interpretation 48 liabilities are classified as a current liability in the registrant’s balance sheet, a registrant should include that amount in the “less than 1 year” column of its contractual obligations table. Similarly, the contractual obligations table should include any noncurrent Interpretation 48 liabilities for which the registrant can make a reasonably reliable estimate of the amount and period of related future payments (e.g., uncertain tax positions subject to an ongoing examination by the respective taxing authority for which settlement is expected to occur after the next operating cycle).

Often, however, the timing of future cash outflows associated with some Interpretation 48 liabilities is highly uncertain. A registrant might be unable to make reasonably reliable estimates of the period of cash settlement with the respective taxing authority (e.g., unrecognized tax benefits for which the statute of limitations might expire without examination by the respective taxing authority). In such cases, a registrant could exclude Interpretation 48 liabilities from the contractual obligations table or disclose such amounts within an “other” column added to the table. If any Interpretation 48 liabilities are excluded from the contractual obligations table or included in an “other” column, a footnote to the table should disclose the amounts excluded and the reason for the exclusion.

⁹ SEC Regulation S-K, Item 303(a)(5).

Registrants should also consider the adequacy of their critical accounting policy disclosures relating to income taxes. A critical accounting policy is one that (1) is important to the portrayal of the company's financial condition and results, and (2) requires management's most difficult, subjective, or complex judgments. The SEC staff focuses on the importance of providing investors with an understanding about how management forms its judgments about future events, including the variables and assumptions underlying the estimates, and the sensitivity of those judgments to different circumstances. Given Interpretation 48's recent issuance and the expected increased scrutiny associated with the accounting for income taxes, now may be a good time to look at whether the MD&A clearly portrays the significance of management's assumptions about future events.

Other Deloitte & Touche LLP Resources

- [*Uncertainty in Income Taxes: A Roadmap to Applying Interpretation 48.*](#)

Use of Experts and Consents

Example of SEC Comments

- We note various references to the use of third-party valuations. . . . Since reference is made to the use of valuations, the expert(s) that prepared the valuations should be named, and the consent of the expert(s) should be filed as exhibits. Alternatively, you may elect to revise your disclosures to eliminate all references to the use of experts and/or third party valuations. Please advise and revise accordingly.

At the 2007 AICPA Conference, Ms. Stephanie Hunsaker, associate chief accountant in the SEC's Division of Corporation Finance, discussed the use of experts and consents. She indicated that during the past year, the SEC "staff has seen an increase in the number of companies that have chosen to [refer to] an independent valuation firm or other expert in both" registration statements under the Securities Act of 1933 and periodic reports under the Securities Exchange Act of 1934 (i.e., Forms 10-K and 10-Q). These references will most likely increase with the expanded use of fair value in the future. Some common examples include references to:

- A valuation firm about the valuation of a registrant's common and preferred stock in an IPO.
- A valuation firm about the determination of goodwill impairment.
- A valuation firm about the determination of asbestos liability.
- Petroleum engineers about the evaluation of oil and gas reserves.

The SEC staff has said there is no requirement to refer to an independent valuation firm or other expert in registration statements or periodic reports. If a registrant does not refer to the expert, the registrant is not required to name the expert or provide the expert's consent. However, registrants that choose to refer to an expert should consider the following:

Periodic Reports

For registrants that choose to refer to an independent valuation firm or other expert in periodic reports, such as Form 10-K or 10-Q, no consent is required. However, the SEC staff expects the referenced expert to be named in the filing. By referring to the

expert, management appears to transfer at least some responsibility to a third party, and investors have the right to know upon whom management has relied. Further, if the registrant incorporates a periodic report by reference in a registration statement, the below requirements apply.

Registration Statements

A consent is required when a registrant refers to experts in registration statements under Rule 436 of Regulation C as follows:

If any portion of the report or opinion of an expert or counsel is quoted or summarized as such in the registration statement or in a prospectus, the written consent of the expert or counsel shall be filed as an exhibit to the registration statement and shall expressly state that the expert or counsel consents to such quotation or summarization.

The phrase “quoted or summarized” in Rule 436 of Regulation C is broadly interpreted by the SEC staff. **The SEC staff has indicated that *any* reference to the expert, whether as the sole basis for a conclusion or as one of many factors considered by management in its evaluation, would require a consent.**

Even if a consent is required in a registration statement, the expert does not need to be named in the “Experts” section because the SEC forms do not require that disclosure.

Disclosure in the Consent

Ms. Hunsaker indicated that “the valuation firm or other expert may state that it does not admit to being an expert, but it may not deny that it is an expert. In addition, the expert may not attempt to limit its liability under Section 7 and 11 of the [1933] Act or include language which attempts to state a legal conclusion as to which party is responsible for which item of disclosure.” For example, an expert may not include disclosure in a consent “stating that the responsibility of the valuation rests solely with the registrant.”

Other Areas of Frequent SEC Comment

Asset Retirement Obligations

The SEC staff often issues comments questioning why a company did not record an asset retirement obligation when disclosures in the filing appear to indicate that the company may have asset retirement obligations. Companies that include disclosures such as “settlement dates are unknown at this time,” or other similar language concerning the inability to reasonably estimate the fair value of asset retirement obligations, may receive an SEC staff comment asking for more detail about how the company reached this conclusion and the extent of the company’s uncertainty. Registrants must disclose (1) that they have not recorded asset retirement obligations that cannot be reasonably estimated and (2) the reason they could not be reasonably estimated under paragraph 22 of Statement 143.

Disclosure Controls and Procedures

Companies must provide quarterly discussion of their disclosure controls and procedures;¹⁰ the language used should conform to the requirements in Rule 13a-15(e) of the Securities Exchange Act of 1934.¹¹ The SEC staff often comments when registrants do not use the proper definition of “disclosure controls and procedures” or when they omit certain language, such as the words “effective” or “ineffective” when drawing conclusions about disclosure controls and procedures. The staff frequently requires registrants to amend their filings to correct the disclosure.

Disclosures Regarding State Sponsors of Terrorism

The U.S. Department of State has designated five countries as state sponsors of terrorism — Cuba, Iran, North Korea, Sudan, and Syria. These countries are subject to U.S. economic sanctions and export controls. Companies that do business in these countries are required to disclose material operations in these locations and any agreements, commercial arrangements, or other contacts with the governments or

¹⁰ Pursuant to Part I – Item 4 of Form 10-Q and Part II – Item 9 of Form 10-K.

¹¹ As required by Regulation S-K, Item 307.

entities controlled by those governments. The SEC staff frequently comments on this subject and believes these disclosures are important to investors. On November 16, 2007, the SEC issued a [concept release](#) on how best to make these disclosures more accessible to investors through its [Web site](#).

Executive Compensation

The SEC staff recently performed a comprehensive review of the executive and director compensation disclosures of 350 public companies from a wide range of industries, after which the staff issued a [report](#) summarizing the feedback that it gave these companies. The publication indicated that Compensation Discussion and Analysis should focus more on analyzing material principles and important factors influencing the registrant's executive compensation policies and decisions. In other words, **how** and **why** did the company arrive at its policies and decisions? According to the publication, "Where we ask a company to add analysis, or enhance its analysis, we do not necessarily think that it should lengthen its disclosure." Rather, the SEC staff prefers more concise disclosures, in plain English with more tables and graphs.

Other Deloitte & Touche LLP Resources

- [September 7, 2007](#), and [October 16, 2007](#), *Heads Ups* on Executive Compensation.

Investments

On the subject of investments, the SEC staff often comments on a company's analysis of impairment. The staff may request support for a company's conclusion that unrealized losses are temporary (e.g., no other-than-temporary impairment that requires recognition has occurred). The staff has requested that companies disclose how they determined the fair value of their investments, including the amount of the impairment loss (if not disclosed separately), and whether the investments have been subsequently sold and, if so, the gain or loss recognized upon sale. The staff may also ask whether the impairment was recorded in the appropriate period. See SAB Topic 5.M for more information about other-than-temporary losses and important factors that a company should consider when evaluating impairment of investments in securities.

Non-GAAP Measures

A non-GAAP financial measure is a numerical measure of a company's historical or future financial performance, financial position, or cash flows that includes or excludes amounts that are not part of the most directly comparable GAAP measure. The SEC staff's comments in this area primarily focus on the level of a company's disclosure. While the staff may question the inclusion of non-GAAP measures in filings, it does not

prohibit them provided that a company has included the required disclosures, particularly disclosures demonstrating the usefulness and purpose of the measures. The following information should accompany a company's disclosure of non-GAAP measures:¹²

- A presentation, with equal or greater prominence, of the most directly comparable financial measure or measures calculated and presented in accordance with Generally Accepted Accounting Principles (GAAP);
- A reconciliation (by schedule or other clearly understandable method), which shall be quantitative for historical non-GAAP financial measures presented, and quantitative, to the extent available without unreasonable efforts, for forward-looking information, of the differences between the non-GAAP financial measure disclosed or released with the most directly comparable financial measure or measures calculated and presented in accordance with GAAP . . . ;
- A statement disclosing the reasons why the registrant's management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding the registrant's financial condition and results of operations; and
- To the extent material, a statement disclosing the additional purposes, if any, for which the registrant's management uses the non-GAAP financial measure that are not [otherwise] disclosed.

The purpose for which management uses the non-GAAP financial measure and the utility of the information to investors should not be boilerplate. If the disclosure does not clearly demonstrate the usefulness of the measure to investors, the SEC staff may conclude that the measure is prohibited.

Other Deloitte & Touche LLP Resources

- [Conditions for Use of Non-GAAP Financial Measures Booklet \(available on Technical Library: The Deloitte Accounting Research Tool\).](#)

Pensions

SEC staff comments on pensions focus primarily on accounting policy decisions and other required disclosures. One such comment relates to the calculation of the market-related value of plan assets (as that term is defined in Statement 87). The SEC staff expects registrants to disclose their accounting policy election for the method used to determine the market-related value of plan assets, since it directly affects pension expense. The staff also comments on the absence of required disclosures for key assumptions, such as the discount rate and other actuarial assumptions used to value a company's pension plan.

Other Deloitte & Touche LLP Resources

- [A Roadmap to the Accounting and Regulatory Aspects of Postretirement Benefits: Including an Overview of Statement 158.](#)

¹² Pursuant to paragraph (e)(1)(i) of Regulation S-K, Item 10.

Appendix A: SEC Staff Review Process

The SEC's Division of Corporation Finance is responsible for reviewing registrants' filings. The Division's staff comprises more than 500 members, primarily accountants and attorneys, organized in 11 industry groups that perform filing reviews. Additional support offices include the Office of the Chief Accountant, Office of the Chief Counsel, and the Office of Mergers and Acquisitions.

Documents Subject to SEC Staff Review

The Division handles reviews of several types of registrant filings, including:

- Registration statements (filings under both the Securities Act of 1933 and the Securities Exchange Act of 1934).
- Proxy statements.
- Form 10-K and related filings under the Securities Exchange Act of 1934 (i.e., Forms 10-Q and 8-K, including Form 8-K, Item 4.01 or Item 4.02).
- Form 20-F.

Selection Process

Section 408(c) of the Sarbanes-Oxley Act of 2002 mandates that all issuers be reviewed no less than once every three years. While the selection process for filing reviews is nonpublic and confidential, Section 408(b) of the Act requires the Division's consideration of the following factors when selecting companies for review:

- Recent material restatement of financial results.
- Significant volatility in stock price.
- Large market capitalization.
- Emerging companies with disparities in price-to-earning ratios.
- Operations that affect a material sector of the economy.
- Other factors the SEC may consider relevant.

While the Division has historically focused on the third factor (issuers with the largest market capitalization), it has also concentrated on the other factors described in Section 408(b) of the Act. In addition, the 11 industry groups in the Division determine the type of review performed on a particular filing and the issues material to their industry.

Types of Reviews

The Division's staff performs the following types of reviews:

- *Preliminary* — This is the initial review of a filing and is the most common type of review. Typically, this review is performed on a registrant's annual report and may lead to a more comprehensive review. This review primarily focuses on the registrant's financial statements and related disclosures.
- *Full* — This review involves the Division's legal and accounting staff and is the most comprehensive review. It can be performed on any type of filing but is generally performed on initial public offering documents and other registration or proxy statements. In addition, typically all documents associated with the selected filing (i.e., recent Forms 10-K, 10-Q, and 8-K) are considered. Information from a company's Web site or in an analyst's report may also be considered.
- *Financial Statement* — This review typically is performed by the accounting staff and focuses on MD&A and the company's financial statements and related disclosures.
- *Legal* — This review is performed by the Division's legal staff and focuses on technical legal aspects of a registrant's filing.
- *Targeted/Monitor* — This review focuses on one or more specific accounting or disclosure issues. The Division's staff may perform targeted reviews as needed. For example, in August 2007, the Division issued comment letters to 350 companies regarding their executive compensation disclosures to help them improve their disclosures about the new rules.

Review Process

Once the Division's staff has completed its review of the selected filing, a comment letter may be prepared and submitted to the company, typically by facsimile. Although the Division's staff usually communicates to registrants via formal written comment letters, occasionally it will comment orally. In such cases, companies are encouraged to document their communications with the SEC in writing and submit them to the staff for final clearance, as if the comments were received in the traditional manner.

A company that receives an SEC comment letter should generally respond within the time frame indicated in the letter (see [Appendix B](#) for more information about responding to SEC comment letters). The Division's staff may have further questions for the company and may send additional comment letters to address these concerns. The company should continue to respond to any requests for more information until it receives a letter from the Division stating that the Division has no further comments. A company that does not receive a completion letter within a reasonable amount of time after submitting a response letter should call its SEC staff reviewer (named in the letter) to ask about the status of the review. If the review is complete, the company should request a completion letter.

Appendix B: Best Practices for Managing Unresolved SEC Comment Letters

The following best practices are intended to help SEC registrants resolve any staff comment letters in a timely manner. Unresolved comments may affect a registrant's ability to issue financial statements and an auditor's ability to issue the current-year audit report.

- Consider the impact the comment letter may have on your ability to issue the financial statements.
- Consult with your SEC legal counsel about the impact the comment letter may have on the certifications contained in your Form 10-K.
- Consult with your auditors to discuss the impact the comment letter may have on their ability to issue the current-year audit report.
- Review the comment letter immediately and respond to the SEC staff reviewer (named in the letter) within the time indicated in the comment letter (usually 10 business days). If possible, do not request an extension, since this may delay resolution of the comment letter. However, in certain circumstances, a registrant may consider requesting an extension to provide a response that addresses all of the staff's comments.
- If you do not fully understand any specific comment, contact your SEC staff reviewer for clarification so that you can provide an appropriate response.
- Because some comments may require disclosures in future filings, consider including such disclosures in the response letter to potentially eliminate additional requests from your SEC staff reviewer.
- Maintain contact with your SEC staff reviewer and make the reviewer aware of your required timing (on the basis of your current-year filing deadlines).

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- If you have not received a follow-up letter or been contacted within two weeks of filing the initial response letter, contact your SEC staff reviewer to determine the status of the comments. Promptly address any follow-up questions.
- If you are uncertain about whether your review has been completed without further comments, ask the SEC staff reviewer about the status of the review. If the review is complete, ask the reviewer for a completion letter.

Disclosure Requirements

In addition, under the Securities Offering Reform,¹³ for fiscal years ending on or after December 1, 2005, large accelerated filers, accelerated filers, and well-known seasoned issuers must disclose in their Forms 10-K the substance of any material unresolved SEC staff comments that were issued 180 or more days before the end of the current fiscal year.

¹³ The SEC adopted final rules, effective as of December 1, 2005, which modified the registration, communications, and offering processes under the Securities Act of 1933.

Appendix C: Tips for Searching the SEC's Comment Letter Database

The SEC releases comment letters and responses on EDGAR no earlier than 45 days after the review of the filing is completed. Database search tips are available on the SEC's [Web site](#).

Companies may also search the database on a quarterly basis as part of their financial statement review process. A company could designate an individual to look at both industry-related and other comments to gain insights into accounting and disclosure matters that the SEC staff may deem significant to investors. Registrants can use this information to improve their overall disclosure.

Appendix D: Deloitte & Touche LLP Resources

Deloitte & Touche LLP Publications

In addition to this publication, Deloitte & Touche LLP has a range of publications to assist with SEC-related matters. These include:

Heads Up

Highlights of the 2007 AICPA National Conference on Current SEC and PCAOB Developments

SEC Holds Roundtables on IFRSs

Major Changes to Business Combination Accounting as FASB and IASB Substantially Converge Standards

XBRL U.S. GAAP Taxonomy Made Available for Public Comment

SEC Removes Reconciliation Requirement, Approves Smaller Public Company Rules

SEC Regulations Committee and SEC Staff Hold Third Meeting of 2007

ESOARS Take Off — SEC OKs Use of a Surrogate to Value Employee Share Options

SEC Feedback on Executive Compensation Disclosures: “Where’s the Analysis?”

SEC Staff Issues Comment Letters on Executive Compensation Disclosures

The Shift Toward IFRSs and Its Impact on U.S. Companies

SEC Regulations Committee and SEC Staff Hold Second Meeting of 2007

SEC Provides Further Relief for Smaller Public Companies

SEC Proposes Easing Requirements for Foreign Filings

SEC Tackles a Wide Range of Topics

SEC and PCAOB Approve New Section 404 Guidance: No Additional Delay for Non-Accelerated Filers

Expected SEC Actions Will Increase Relevance of IFRSs in the U.S.

SEC Regulations Committee and SEC Staff Hold First Meeting of 2007

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SEC Discusses Improvements to Section 404 of the Sarbanes-Oxley Act

SEC Clarifies Views on the Design of Market-Based Employee Stock Option Valuation Model

SEC Discusses Ramifications of Matching Critical Terms in Hedge Strategies; Best Practices for Managing Unresolved SEC Comment Letters

SEC and PCAOB Update

Financial Reporting Alerts

SEC Extends the Use of the Simplified Method in SAB 107 Under Certain Circumstances

CAQ Update — Key Accounting Issues and the Credit Environment

Key Accounting Issues and the Current Credit Environment

Error Made by Companies in Adopting Statement 158's Recognition Provisions

Accounting Alerts

SEC Expresses Concerns About Financial Reporting of Certain Strategies Related to the Adoption of Statement 159

SEC Alerts

SEC Issues Letter on Filing Restated Financial Statements for Errors in Accounting for Stock Option Grants

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Did You Know . . . ?

Deloitte & Touche LLP's SEC Reporting Interpretations Manual includes interpretive guidance and more than 45 Q&As on business combinations topics, including:

- Whether separate financial statements are required for an acquired entity.
- How many periods of separate financial statements are required for an acquired entity.
- Which documents filed with the SEC (i.e., Forms 8-K, 10-K, and 10-Q) require separate financial statements of an acquired entity.

Look for additional guidance over the next few months. Future sections of the manual will include equity method investments and unconsolidated subsidiaries, guarantor financial statements, business dispositions, carve-outs, and pro forma financial information. The SEC Reporting Interpretations Manual is available on Technical Library: The Deloitte Accounting Research Tool. For more information, including subscription details and an online demonstration, visit www.deloitte.com/us/techlibrary.

Appendix E: Glossary of Standards

FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements*

FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*

FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*

FASB Statement No. 157, *Fair Value Measurements*

FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*

FASB Statement No. 143, *Accounting for Asset Retirement Obligations*

FASB Statement No. 142, *Goodwill and Other Intangible Assets*

FASB Statement No. 141, *Business Combinations*

FASB Statement No. 141(R), *Business Combinations*

FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*

FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*

FASB Statement No. 131, *Disclosures About Segments of an Enterprise and Related Information*

FASB Statement No. 128, *Earnings per Share*

FASB Statement No. 123(R), *Share-Based Payment*

FASB Statement No. 107, *Disclosures About Fair Value of Financial Instruments*

FASB Statement No. 87, *Employers' Accounting for Pensions*

FASB Statement No. 5, *Accounting for Contingencies*

FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*

FASB Staff Position No. FIN 48-1, "Definition of Settlement in FASB Interpretation No. 48"

Statement 133 Implementation Issue No. G7, "Cash Flow Hedges: Measuring the Ineffectiveness of a Cash Flow Hedge Under Paragraph 30(b) When the Shortcut Method Is Not Applied"

Statement 133 Implementation Issue No. E23, "Hedging — General: Issues Involving the Application of the Shortcut Method Under Paragraph 68"

EITF Issue No. 05-2, "The Meaning of 'Conventional Convertible Debt Instrument' in Issue No. 00-19"

EITF Issue No. 03-13, "Applying the Conditions in Paragraph 42 of FASB Statement No. 144 in Determining Whether to Report Discontinued Operations"

EITF Issue No. 03-6, "Participating Securities and the Two-Class Method Under FASB Statement No. 128"

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"

EITF Issue No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments"

EITF Issue No. 00-21, "Revenue Arrangements With Multiple Deliverables"

EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock"

EITF Issue No. 98-5, "Accounting for Convertible Securities With Beneficial Conversion Features or Contingently Adjustable Conversion Ratios"

EITF Issue No. 98-3, "Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business"

EITF Issue No. 87-24, "Allocation of Interest to Discontinued Operations"

EITF Topic No. D-101, "Clarification of Reporting Unit Guidance in Paragraph 30 of FASB Statement No. 142"

EITF Topic No. D-98, "Classification and Measurement of Redeemable Securities"

APB Opinion No. 22, *Disclosure of Accounting Policies*

APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued With Stock Purchase Warrants*

AICPA Statement of Position 97-2, *Software Revenue Recognition*

AICPA Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*

SEC Regulation S-X, Article 11, "Pro Forma Financial Information"

SEC Regulation S-X, Rule 11-01, "Presentation Requirements"

SEC Regulation S-X, Rule 5-03(b), "Income Statements"

SEC Regulation S-X, Rule 3-16, "Financial Statements of Affiliates Whose Securities Collateralize an Issue Registered or Being Registered"

SEC Regulation S-X, Rule 3-10, "Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered"

SEC Regulation S-X, Rule 3-09, "Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons"

SEC Regulation S-X, Rule 3-05, "Financial Statements of Businesses Acquired or to Be Acquired"

SEC Regulation S-K, Item 307, "Controls and Procedures"

SEC Regulation S-K, Item 303, "Management's Discussion and Analysis of Financial Condition and Results of Operations"

SEC Regulation S-K, Item 302, "Supplementary Financial Information"

SEC Regulation S-K, Item 10, "General"

SEC Staff Accounting Bulletin No. 110, codified as part of SAB Topic 14.D.2, "Share-Based Payment: Certain Assumptions Used in Valuation Methods — Expected Term"

SEC Staff Accounting Bulletin No. 107, codified as SAB Topic 14, "Share-Based Payment"

SEC Staff Accounting Bulletin Topic 14.F, "Classification of Compensation Expense Associated With Share-Based Payment Arrangements"

SEC Staff Accounting Bulletin No. 104, codified as SAB Topic 13, "Revenue Recognition"

SEC Staff Accounting Bulletin Topic 5.M, "Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities"

SEC Staff Accounting Bulletin No. 74, codified as SAB Topic 11.M, "Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period"

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SEC Staff Accounting Bulletin SAB Topic 11.B, "Depreciation and Depletion Excluded From Cost of Sales"

SEC Accounting Series Release No. 268 (FRR Section 211), *Redeemable Preferred Stocks*

SEC Form 8-K, Section 4 — "Matters Related to Accountants and Financial Statements"

Item 4.01, "Changes in Registrant's Certifying Accountant"

Item 4.02, "Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review"

SEC Regulation C, Rule 436, "Consents Required in Special Cases"

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