



U.S. Securities and Exchange Commission

Speech by SEC Staff: International Reporting Issues

Remarks by

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Thank you. It's a pleasure to have a chance to talk with you again. Craig Olinger has provided an overview of the SEC's filing process and has highlighted some questions the SEC staff has received recently from registrants and their auditors. I want to discuss the protocol for submissions to the Chief Accountant's office and three recent Staff Accounting Bulletins relating to earnings management issues. I also want to focus on the importance of compliance with accounting standards and will illustrate this point in the context of some recent issues relating to the application of the standards published by the International Accounting Standards Committee (IASC) in foreign issuer filings. I'll wrap up with a brief summary of our concept release on International Accounting Standards (IAS).

Let me begin with a brief summary of the protocol for submissions to the Office of the Chief Accountant.

Protocol for Submissions to OCA

Last year we issued a Protocol for Registrant Submissions to the Office of the Chief Accountant. Registrants and their auditors are encouraged to submit on a prefiling basis accounting, financial reporting, and auditing questions, especially those involving unusual, complex, or innovative transactions for which no clear authoritative guidance exists. These submissions are to be

sent to the Office of the Chief Accountant, with a copy also submitted to Robert Bayless, Chief Accountant of the Division of Corporation Finance.

In your initial communication, we ask that you inform us of any current or previous discussions or correspondence with the staffs from the Division of Enforcement, Corporation Finance, or any other Division or Office regarding the issues in the submission. We have appointed a Management Assistant in our office who will be happy to confirm to you whether your submission has been received. Questions concerning the age, form, and content of financial statements required to be included in a filing should be sent directly to the Chief Accountant of the Division of Corporation Finance, Division of Investment Management, or Division of Market Regulation, as appropriate.

In order to encourage registrants to submit or discuss new or emerging transactions or products, we do accept informal, oral inquiries from registrants with their accounting firm's national office participation, if applicable, as time permits. Generally, these inquiries involve broader, emerging issues that are not registrant specific. However, because of concerns that a clear understanding of the facts may not be accomplished through oral communications, we believe the registrant inquiry process is best accomplished through written submissions on a named basis, and written registrant submissions on a named basis take priority over no-name inquiries.

If a registrant and its auditor want to meet with SEC staff, we ask for sufficient advance notice and a written submission of the issue is required, preferably at least five business days before such meeting. Upon resolution of an issue, the registrant should prepare and send to the staff a letter describing the registrant's understanding of the SEC staff's position.

With that brief summary of how OCA addresses registrant submissions, let me now turn to issues relating to earnings management and discuss three recent Staff Accounting Bulletins (SABs).

Earnings Management

The SEC staff addressed a number of earnings management issues in three SABs issued last year: SAB 99, *Materiality*, SAB 100, *Restructuring and Impairment Charges*, and SAB 101, *Revenue Recognition*. Let me begin with SAB 99 on materiality.

SAB 99

Two preliminary points I want to stress are, first, SAB 99 focuses on materiality concepts in preparing and auditing financial statements. And second, it is based on existing case law, and accounting and auditing literature that is cited in the SAB. Even though there is nothing new in SAB 99, we believe the SAB will help ensure the quality of financial reporting because it addresses our concern about the increasing tendency of some registrants, with the acquiescence of the auditors of their financial

statements, to manage earnings by designating certain transactions and events as immaterial and then accounting for those transactions and events in a manner that may not conform with GAAP.

The response to the first question in SAB 99 states that use of a percentage ceiling test alone to make materiality determinations about an item is not acceptable. While the staff has no objection to the use of a percentage threshold as an initial assessment of materiality, exclusive use of such thresholds has no basis in law or in the accounting literature. The staff stresses that evaluations of materiality require registrants and auditors to consider **all** of the relevant circumstances, and that there are circumstances in which misstatements below that percentage threshold could be material. Some of the circumstances listed in SAB 99 that should be considered are:

- whether the misstatement masks a change in earnings or other trends,
- whether the misstatement hides a failure to meet analysts' consensus expectations for the enterprise,
- whether a misstatement changes a loss into income or vice versa,
- whether the misstatement concerns a segment of the registrant's business that plays a significant role in the registrant's present or future operations or profitability,
- whether the misstatement affects compliance with loan covenants or other contractual requirements, and
- whether the misstatement has the effect of increasing management's compensation.

The SAB also notes that even though a misstatement of an individual amount may not cause the financial statements to be materially misstated, it may, when aggregated with other misstatements, render the financial statements taken as a whole to be materially misleading. SAB 99 provides guidance on when and how to aggregate and net misstatements to see if they materially misstate the financial statements.

The SAB also notes that consideration of potential market reactions to disclosure of a misstatement is, by itself, too blunt an instrument to be depended on in considering whether a fact is material. But when management or the auditor expects—such as when they are aware of an historical pattern of significant market reaction—that a known misstatement may result in a significant positive or negative market reaction, that reaction should be taken into account when assessing materiality.

The response to the second question in SAB 99 notes that intentional misstatements, even of small amounts, that were made to manage earnings may be inappropriate. Some have asked if this means that all unadjusted differences must be recorded. Both footnote 18 and footnote 50 note that intentional misstatements do not include insignificant errors and omissions that may occur in systems and recurring processes in the normal course of business.

SAB 99 also emphasizes the requirement of registrants to maintain books,

records, and accounts which, in reasonable detail, accurately and fairly reflect the transactions of a company. SAB 99 sets forth various factors, in addition to those used to evaluate materiality, that a company may consider in deciding whether a misstatement violates its obligation to keep books and records that are accurate "in reasonable detail." Some of these factors are:

1. the significance of the misstatement, which means inconsequential misstatements may be treated differently than more significant ones,
2. how the misstatement arose, for example, whether it is part of an effort to manage earnings or an insignificant flaw in an operations system,
3. the cost of correcting the misstatement, and
4. the clarity of the authoritative accounting guidance with respect to the misstatement.

SAB 99 also reminds auditors of their obligations under Section 10A of the Securities Exchange Act of 1934 and auditing standards to inform management and, in some cases, audit committees of illegal acts, such as violations of the books and records provisions of the Exchange Act, coming to the auditor's attention during the course of an audit.

Finally, SAB 99 makes a clear statement that the authoritative literature takes precedence over industry practice that is contrary to GAAP.

SAB 100

SAB 100 addresses four issues: acquisition loss accruals acquired in a purchase business combination, restructuring charges, asset impairments, and inventory valuation allowances. Let me discuss the first three of these issues.

- **Acquisition Loss Accruals**

Acquisition loss accruals such as environmental and warranty liabilities are often recognized as part of a business combination. We have seen cases where the acquiring company uses materially different projections of undiscounted cash flows for purposes of measuring the fair value of such loss accruals and other contingent liabilities assumed in a purchase business combination than those used by the acquiree. While generally accepted accounting principles require that liabilities assumed in a purchase business combination be recorded at fair value (that is, at present values of amounts to be paid determined at appropriate current market interest rates), the staff believes that it is inappropriate to add cushions to those estimates of fair value by creating differences in undiscounted expected future cash flows. That is, the staff believes that the buyer's estimated future undiscounted cash flows relating to contingent liability balances and other loss accruals assumed in a purchase business combination should not be materially different from the seller's pre-sale estimates.

- **Restructuring Charges**

SAB 100 also addresses restructuring charges. The staff believes that the Emerging Issues Task Force ("EITF") set high standards for plan specificity when it stated in EITF 94-3, "[t]he exit plan specifically identifies all significant actions to be taken to complete the exit plan." SAB 100 outlines several factors the staff believes should be considered in evaluating the specificity of the plan. First, the determination of whether a particular exit plan is sufficiently detailed should include consideration of both the qualitative and quantitative aspects of the plan. The staff believes that an exit plan identifies specifically all significant actions if it is sufficiently detailed such that the company can and will use it to (1) evaluate the performance of those responsible for executing the exit plan and (2) identify and react to plan versus actual variances. That is, the staff would generally expect a company's exit plan would be at least comparable to other operating and capital budgets the company prepares in terms of the level of detail and reliability of estimates.

Second, the staff believes that an exit plan would not be sufficiently detailed if it is more likely than not that either the exit plan itself, or significant actions identified within the exit plan, will be materially revised in response to events or circumstances that are likely to occur. *All* significant actions must be documented in sufficient detail with respect to geographic locations, estimated costs, and expected cash flows.

Third, the EITF indicated that while all significant actions must be identified at the commitment date, accruals could be made only for those costs associated with specifically identified significant actions that can be reasonably estimated. The staff believes that the ability to reliably estimate encompasses both the initial development of the exit plan and its subsequent implementation.

Fourth, the key assumptions and key components used in making the detailed calculations for the plan must have a reasonably supportable basis.

Since we all realize that actual results may vary from original estimates, the original liability, or loss accrual may require adjustment after it is initially established. The staff would expect a registrant, at each balance sheet date, to review the propriety of adjusting (increasing or decreasing) or not adjusting the liability or loss accruals pursuant to GAAP. For example, if a restructuring reserve was initially recorded based on a set of facts, and in a later period the facts changed such that continued recognition of a restructuring reserve was no longer appropriate, then the loss accrual should be reversed on a timely basis in that period and should be adjusted against the financial statement line item for which the reserve was originally recorded. In addition, the staff expects all the disclosures as required by EITF 94-3 or 95-3 to be disclosed in all periods, including interim periods, beginning with the period in which the exit plan is consummated until the exit plan is completed.

- Asset Impairments

Another area SAB 100 addresses is asset impairments. Statement of Financial Accounting Standards ("SFAS") No. 121 establishes the guidance for impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used. SFAS 121 provides that when management, having the authority to approve the action, has committed to a plan to dispose of the assets, whether by sale or abandonment, the assets to be disposed of should be reported at the lower of the carrying amount or fair value less costs to sell. The staff believes that registrants also must consider the criteria in Accounting Principles Board ("APB") Opinion No. 30 and EITF 94-3 to determine if a plan is sufficiently robust to designate the assets as assets to be disposed of. The staff believes that a necessary condition of a plan to dispose of assets in use is that management has the current ability to remove the assets from operations.

For example, the staff would object if a registrant were to record an impairment of its mainframe computer if that asset cannot be taken out of service and abandoned prior to installing the new, but not yet available, mainframe computer. The operational requirement to continue to use the asset is indicative that the asset is held for use. The staff does not believe this guidance means that assets to be sold must be removed from service in order to be designated as assets held for disposal. Rather, the assets must be able to be removed from service upon identification of a buyer or receipt of an acceptable bid, but can otherwise remain in service provided the criteria in SFAS 121 have been met. If a buyer is found and an acceptable offer is received, but the seller must retain the assets for some period due to ongoing operational needs, the criteria for "to be disposed of" treatment has not been met.

SAB 100 also reminds registrants that they must continually evaluate the appropriateness of useful lives assigned to long-lived assets, including identifiable intangible assets and goodwill. The staff does not view the recognition of an impairment charge to be a substitute for choosing the appropriate initial amortization or depreciation period or subsequently adjusting this period as company or industry conditions change.

SAB 101

SAB 101 addresses revenue recognition. This SAB was intended, in part, to bring the authoritative literature that is included in various standards into a single retrievable format. As a result, the SAB and its fifty-two footnotes provide a roadmap for the preparer and user in analyzing existing literature.

Under GAAP, revenue is recognized when it is earned and realized or realizable. To satisfy these conditions, SAB 101 describes four underlying conditions that must exist. First, there must be persuasive evidence that an arrangement exists. Second, delivery of goods must have occurred or services rendered. Third, the price is fixed or determinable. And finally, collectibility is reasonably assured.

The SAB also provides guidance on topics such as "bill and hold" arrangements and contingent sales. The bill and hold guidance in the SAB is taken word-for-word from the various Commission releases in enforcement matters addressing this issue. With the issuance of this SAB, this guidance is now available in a more easily accessible format.

The SAB also addresses revenue to be received from service transactions. It notes that service transactions are explicitly *not* addressed by SFAS No. 48. The SAB also notes that service revenues are to be recognized ratably as the services are performed and not upfront when cash is received or an agreement is entered into.

Finally, the SAB notes that registrants should make full disclosure of the revenue recognition policies in addition to the required disclosures in Management's Discussion and Analysis ("MD&A").

Let me now discuss the importance of compliance with accounting standards and illustrate this point in the context of some recent registrant matters the staff has addressed. I'm going to focus on some IAS reporting issues since I know better than to raise German or French or U.K. GAAP issues with a room full of experts! Let me begin with a couple of issues relating to the accounting for subsidiaries.

Accounting for Subsidiaries

The staff has noted a number of situations where an entity appropriately was considered a subsidiary but was not accounted for in accordance with IAS 27, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries* (IAS 27). Like U.S. GAAP, IAS 27 requires consolidation of all subsidiaries. IAS 27 does provide certain limited exceptions to the general rule of full consolidation. In some situations we've seen, the subsidiaries were accounted for using proportionate consolidation -- a method not allowed under IAS 27 for accounting for subsidiaries. In these cases the registrants asserted that proportionate consolidation was used for all investments as a matter of accounting policy because the effect of not using full consolidation was immaterial.

In other situations, the registrants asserted that the policy of not consolidating the subsidiaries was industry practice. This was particularly prevalent when a subsidiary operated in an industry that was different from the one its parent operated in. While that may be practice, it isn't in compliance with IAS 27, which has very clear requirements: exclusion from full consolidation of subsidiaries is not justified just because those subsidiaries operate in different business activities or industries.

In still other situations, subsidiaries were characterized inappropriately as joint ventures and accounted for using either the equity method or proportionate consolidation. In many of these instances, the parent owned more than a simple majority interest in the subsidiary. In one instance the registrant indicated in its footnotes that "...[a]lthough certain of the...ventures

do not meet the technical requirements of joint control, they have been proportionally consolidated as the impact of the difference between proportional and full consolidation or equity accounting...is not material." This type of accounting is not consistent with the requirements of IAS 27.

In all of these situations the U.S. GAAP reconciliation included a material reconciling item adding in the effect of line-by-line consolidation. In each of these instances, the staff was unable to concur with the registrants' conclusions and required restatement of the primary financial statements.

Let me turn now to accounting for associates.

Accounting for Associates

The staff recently dealt with a couple of issues involving the accounting for certain investments in associates under IAS 28, *Accounting for Investments in Associates* (IAS 28). Under IAS 28, an entity is presumed to have significant influence if it acquires 20% or more of the voting power of an investee. This presumption may be overcome in exceptional circumstances where it is demonstrated clearly that such influence does not exist.

The question I'd like to focus on is what constitutes significant influence under IAS 28. Some registrants have asserted that "significant influence" as defined in IAS 28 requires **active** participation. They believe that one must actually take steps to influence the investee and that passive participation and simply **having** the ability to influence is not enough. The staff disagreed with these assertions. IAS 28 defines significant influence as "...the **power** to participate in the financial and operating policy decisions of the investee..." [emphasis added] The phrase "**power** to participate" implies having the capacity or ability to accomplish something -- in this case participation in the decision-making process. We do not believe that "power to participate" requires active participation as a condition for applying equity method accounting to an investee.

Another issue that the staff has addressed relates to the kind of circumstances that would demonstrate clearly that the presumption of significant influence has been overcome. In one case the staff considered how corporate governance would impact the determination of whether the presumption of significant influence was overcome.

In some European countries, enterprises have a two-board structure -- a supervisory board and a management board. The responsibilities of the supervisory board in these systems typically include, among other things, the ability to appoint the members of the management board and the consent to or approval of major corporate decisions. Recently we were asked to concur with use of the cost method of accounting for an investee where an investor had over 20% of the equity of the investee, and where employees of the investor were members of the supervisory board of the investee. The investor asserted that participation in the supervisory board, rather than the management board, overcame the presumption of an ability to influence the

investee because the supervisory board is not responsible for day-to-day management of a company.

The staff disagreed with the investor's assertion. The supervisory board may not make the day-to-day decisions, which generally are the responsibility of the management board. However, we believe that the supervisory board does participate in an entity's decision-making process. The staff believes that participation on a supervisory board confirms rather than rebuts an investor's ability to influence an associate.

We also have noted circumstances where registrants have asserted that a difference exists between IASC standards and U.S. GAAP regarding the applicability of the equity method of accounting and how the presumption of significant influence should be assessed. Both IAS 28 and U.S. GAAP list the same factors that are indicative of significant influence. However, some have argued that the existence of FASB Interpretation No. 35, *Criteria for Applying the Equity Method of Accounting Investments in Common Stock* (FIN 35), creates a difference in when the equity method of accounting is applied using IASC standards versus when it is applied under U.S. GAAP. Although IAS 28 does not include the examples outlined in FIN 35, the staff believes that the examples in FIN 35 generally would be indicators of a lack of significant influence under IAS 28.

These are just two areas where the staff has seen non-compliance with IASC standards. Let me now make some general remarks relating to the assertion of compliance with accounting standards and U.S. GAAP reconciliations.

Compliance with Accounting Standards

Auditors have addressed clients not fully complying with accounting standards (including IASs) in a variety of ways. Some auditors simply do not comment explicitly on compliance. This is common practice when the statement of compliance (or partial compliance) is in the footnotes. In other cases auditors may express an opinion on conformity with the "accounting principles described in the footnotes" which typically mixes IASs and other principles. We also have seen situations where the auditors appropriately have issued a qualified opinion.

If financial statements are represented to be in compliance with a body of accounting standards (including IASs) either on their face or in the footnotes, nothing less than full compliance is acceptable. In the context of IASs, the requirements of IAS 1 are clear. Besides requiring enterprises that comply with IASC standards to disclose that fact, IAS 1 also indicates that financial statements should not be described as complying with IASC standards unless they comply with all the requirements of each applicable standard and each applicable interpretation of the Standing Interpretations Committee. This also would preclude presentation of financial statements where a departure from IASC standards is disclosed in either the auditor's report or in the notes to the financial statements.

Let me be very clear that these comments are not a criticism of IASs. Rather, they're meant to support those standards. I'm also not suggesting that we hold registrants that use IASs to a higher standard of compliance; I have the same expectation of full compliance with every registrant, regardless of the body of accounting standards used.

Let me now offer a couple of remarks about U.S. GAAP reconciliations.

U.S. GAAP Reconcilliations

The staff has noted a number of situations involving reconciling items that appear to be the result of non-compliance with home country accounting standards (including IASs) and not the result of a difference between those standards and U.S. GAAP. As such, there should not be a reconciling item. In many of these situations, the registrant asserted that the application of the relevant standards was insignificant or immaterial; yet they were significant enough to be identified as a reconciling item for purposes of the U.S. GAAP reconciliation. The staff has challenged these situations and will continue to do so. The U.S. GAAP reconciliation cannot be used in lieu of full compliance with the accounting standards used to prepare the primary financial statements. In addressing these issues the staff has required restatement of the financial statements.

Let me now close with a brief comment about the Commission's Concept Release on International Accounting Standards.

SEC Concept Release

Commissioner Hunt spoke yesterday about the SEC's commitment to promoting high quality financial reporting and supporting efforts to develop a high quality global financial reporting structure. There are a few specific items covered by the Concept Release that I'd like to reinforce.

The SEC staff has done substantial work with respect to IASC standards, both directly and through IOSCO, the International Organization of Securities Commissions. Those who have read our comment letters on IASC standards know that there are areas – like accounting for intangibles – where the staff has significant concerns about the quality of the information produced by applying the IASC standards. But those people also know that there are places, for example, in the area of business combinations, where many argue the IASC has provided better guidance than U.S. GAAP. Some of the questions posed in the Concept Release relate specifically to the IASC standards, and give people a chance to provide input to the Commission with respect to its technical concerns about IASC standards. Other questions are ones we've identified while working on international reporting issues, and relate to any financial statements of foreign issuers, whether or not those financials were prepared using IASC standards.

The Concept Release raises a number of complex and difficult issues. Some have suggested that the SEC is asking these questions to look for excuses to

criticize the IASC standards. That is not the case. The issues raised in the release are real ones that we have to deal with in formulating any rule proposal that affects the current filing requirements for foreign issuers. As a result, we are seeking input based on the collective experience of those who work daily preparing financial statements, auditing financial statements, or using financial statements to make investment decisions. The purpose of the Release is to tap into that experience, and the Commission would welcome responses to the Concept Release from those outside the United States, including people like those in this room, who have demonstrated an interest in and commitment to financial reporting. I encourage each of you to get the release from the SEC's website and to try to respond to some or all of the questions it poses. Your responses on this critical issue will be carefully considered.

The comment period on the Concept Release ends May 23 and I encourage all of you to respond. We intend to analyze the comments we receive promptly so that we can advise the Commission regarding rulemaking, which would be necessary to reduce or remove the current US GAAP reconciliation requirement.

Conclusion

Having put in my plug for the SEC's Concept Release, I'd like to wrap up with some thoughts about promoting development of a high quality global financial reporting structure at a very practical level. The first step in promoting convergence of accounting standards is developing a body of standards that are internationally accepted. However, convergence will not be realized until those standards are rigorously interpreted and applied. This means settling for nothing less than full compliance. The bottom line is – compliance matters.

Thank you.

<http://www.sec.gov/news/speech/spch359.htm>