Statement by SEC Staff: Remarks Before the 2005 AICPA National Conference on Current SEC and PCAOB Developments

by

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Introduction

Good Afternoon. Today, I am going to speak about an issue that is as old as accounting itself - materiality. I'm also going to speak about a business combination issue that has recently received a lot of attention.

Quantification of Errors

I started off by saying that I am going to talk about materiality, but I am actually going to talk mainly about something you have to do before you can even perform a materiality assessment - that is the quantification of errors. Of course, you have to determine what your error is before you can even go through the process of determining if it is material. As Russell Hodge spoke about last year at this conference, not everyone agrees on how to quantify errors that span more than one period. This has been summed up as the rollover versus iron curtain debate.

As a quick recap, the rollover approach quantifies an error as the amount by which the current year income statement is misstated while the iron curtain approach quantifies an error as the amount by which the current year

balance sheet is misstated. These approaches result in different answers when there were errors in the prior year that were not corrected at that time. A simple example is a liability that was overstated by $80 in the prior year and is overstated by $100 in the current year. The rollover approach would quantify the error as the amount by which the current year income statement is misstated, or $20 in this example, while the iron curtain approach would quantify the error as the amount by which the current year balance sheet is misstated, or $100. Obviously, the rollover approach can result in large errors accumulating on the balance sheet as long as the change is immaterial to income in each year. The iron curtain approach, however, is not without its flaws. In this example, if the $80 prior year error was corrected in the current year, the rollover approach would quantify the error as the $80 overstatement of current year income due to the out of period correction, while the iron curtain approach would disregard the error since the end of period balance sheet is correct.

As Russell said last year, we do not believe it is appropriate for diversity to exist in an area as basic as determining the amount of an error. Also, as shown in my examples, both approaches have weaknesses. As a result, Russell reported that we were thinking about ways to resolve the issue. I'm here to report that we are still thinking. You should not take our inaction on this issue over the past year as an indication that we have given up. To the contrary, we have put a great deal of thought into this matter and we are continuing to consider whether and what type of guidance in this area would be appropriate. OCA's current thinking, which is in line with a view Russell expressed last year, is that a better approach may be to quantify errors using both approaches.

A couple of points regarding any guidance we may issue. First of all, we are cognizant of the need to allow sufficient time for registrants to digest any new guidance. Second, we realize that some form of guidance is likely needed to help registrants that are adopting a new quantification approach for the first time. That is an area on which we have spent a considerable amount of time and effort. Our goal is to get registrants on a common approach and to not require restatements for registrants that appropriately applied a previously acceptable approach. Of course, the appropriate application of a previous approach would have required a proper consideration of all qualitative and quantitative factors.

You may be wondering if there is anything you should be doing now. I would recommend a few things. First of all, I recommend that you spend some time to ensure that you understand how you quantify errors. Do you know which approach you use? If you have decentralized operations, does everyone in your company use the same approach? Are there any errors accumulated on your balance sheet that you evaluated to be immaterial because the change in the current year was immaterial? Thinking about these questions will go a long way in getting ready for any guidance we may issue.

Second, you should ensure that you are considering future periods when evaluating errors. SAB 99[1] references AU 380, which states that "matters

underlying adjustments proposed by the auditor but not recorded by the entity could potentially cause future financial statements to be materially misstated, even though the auditor has concluded that the adjustments are not material to the current financial statements."[2]

You may have noticed that this reference to auditing literature is the first time I have mentioned auditing. That is because quantifying errors and evaluating materiality is first a responsibility of the registrant. Auditors need to ensure that they properly quantify and evaluate errors in the process of their audit, but registrants are responsible for preparing materially correct financial statements.

One last area I would like to touch on in the materiality arena is the materiality disclaimer at the end of each FASB standard. In line with my previous comments regarding the consideration of future periods, registrants should ensure they are thinking about future periods when using the materiality disclaimer. For example, not straight-lining lease payments may be immaterial in the current year, but if it will become material in future periods due to lower or higher rents in the later years, you should ensure that you get the accounting right before the differences become material. You also need to ensure that you are continually updating your assessment as to whether or not applying a standard is immaterial. Said another way, the fact that not applying a particular provision in GAAP is immaterial in one period is not a lifetime pass to never apply the provision - instead, materiality should be reconsidered each period.

And one further thought. If you are availing yourself of the materiality disclaimer because you do not like what the standard would do to your financial statements, then you are not applying the disclaimer properly. In that case, you have essentially admitted that you believe that not applying the standard would cause users to view your financial statements differently, which, by definition, makes the difference material.

Preexisting Relationships between Parties to a Business Combination

I would now like to speak for a few minutes about EITF Issue No. 04-1, "Accounting for Preexisting Relationships between the Parties to a Business Combination." Let me start off by saying I will not be giving you all of the answers on 04-1 - there are many questions, and most of the answers are based on facts and circumstances. But at least I thought I could let you in on our thinking for a few issues we have seen within the scope of 04-1.

Pursuant to Issue 04-1, any business combination between parties with a preexisting relationship should be evaluated to determine whether a settlement of the preexisting relationship exists. These are deemed to be multi-element transactions - a business combination and a settlement of a relationship. On the surface, that sounds simple enough. Basically, if you buy a business with which you have a preexisting relationship, determine how much you would have paid (or would have received) to terminate the relationship absent the business combination and that is the amount of your

settlement gain or loss (provided no amounts are already on the balance sheet). I have simplified it somewhat as relationships resulting from executory contracts are not valued at their true fair value. Instead, the settlement gain or loss is the amount by which the contractual terms are favorable or unfavorable to market prices as the Task Force did not want to require settlement gains and losses for at-market contracts that have a fair value due to synergies, customer relationships or other factors. But in any event, the point is that you cannot buy a company with which you have an unfavorable relationship, such as a supply contract or a lawsuit, and bury the buy out of the unfavorable relationship in goodwill.

One issue that has arisen is whether this issue applies to other than 100 percent acquisitions and, if so, how it is applied. The answer is that it applies anytime you have something that qualifies as a business combination. The harder part of the question is how to value the preexisting relationship and that is where facts and circumstances come into play.

For instance, assume you own 40 percent of an entity and another party owns 60 percent and that you have an unfavorable supply contract with the entity. If you buy an additional 15 percent interest in the entity and you, as the new controlling shareholder, have the ability to cancel the supply contract, you would likely have to pay the other shareholder its entire portion of the value of the supply contract since it will be giving up its favorable position in the contract. If, on the other hand, you buy the same 15 percent interest but cannot cancel the contract, you would likely only pay the other shareholder the value of the 15 percent interest in the contract as the other shareholder will still realize value for the 45 percent interest it retained. I do not mean to imply that all valuations will be this straightforward, but the important point is that determining the settlement gain or loss in a partial acquisition is not a simple mathematical exercise - you need to step back and consider all of the facts and circumstances and the impact they would have on the value lost or gained by the other interest holders.

Another area of 04-1 that elicits a lot of discussion is reacquired rights. 04-1 states that an intangible asset should be recorded apart from goodwill when previously granted rights to use the acquirer's intangible assets are reacquired in a business combination. Common examples of such rights are rights to a trade name pursuant to a franchise agreement or rights to technology under a licensing agreement.

The two most common issues we have heard related to reacquired rights pertain to valuation and life. Once again, the answers to these questions are based on facts and circumstances, but here are a few things to think about.

First of all, regarding valuation, you need to value the right as if you were buying a right that you did not previously own. A problem is that the rights are oftentimes not transacted on a standalone basis after the initial sale. For example, a restaurant franchise is granted and the franchisee develops a business using the trade name granted by the franchise agreement. Upon reacquisition, the franchisor typically purchases the entire business, which is

now an operating restaurant. On the surface, it seems intuitive that a mature franchise right such as in this example would be worth more than a new franchise right, but you have to think about what is driving that value. The restaurant's value may be driven by other assets, such as customer relationship intangibles from catering contracts, appreciated real estate, and a strong workforce, which is a component of goodwill.

The appropriate life of the newly recognized intangible asset is not addressed in 04-1. It does say that it is appropriate to recognize a reacquired right as part of a recognized intangible asset, such as trade name. This would seem to indicate that the life of the reacquired right would be commensurate with the life used for the acquirer's existing intangible asset.

It gets a little harder when the reacquired right only granted a license for a limited period of time, say a five year product license. If there are no renewal provisions, some believe that the life of the reacquired right should be limited to the remainder of the five years, even though the acquirer will now have the right for the entire product life cycle, since that is the life of the original license. Others believe that the life of the reacquired right should be based on the total product life cycle as that is the useful life of the license to the acquirer. If you are trying to determine the proper life for such an asset, we would be happy to discuss your facts and circumstances. I would also like to direct your attention to paragraph 41 of the Exposure Draft for the replacement of Statement 141.[3] In it, the FASB has proposed that such rights be amortized over the remaining contractual period of the precombination contract that granted the rights.

Thank you for your time.

Endnotes

1. Staff Accounting Bulletin Topic 1:M, *Materiality.*
2. AU Section 380, *Communication with Audit Committees*, paragraph .09.
3. Proposed Statement of Financial Accounting Standards, *Business Combinations, a replacement of FASB Statement No. 141*, June 30, 2005.

http://www.sec.gov/news/speech/spch120505bkr.htm