



U.S. Securities and Exchange Commission

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. I would like to begin today with a brief discussion regarding breakage and then spend the rest of my time talking about some recent business combination issues, including customer-related intangible assets and new basis of accounting.

Breakage

Let me start off with the topic of "breakage". In an arrangement in which a customer makes a payment in advance of vendor performance, the vendor would recognize deferred revenue at the time the payment is received. In some cases, the customer will, for various reasons, not end up demanding full performance. This is often referred to as "breakage." The question is when can the vendor derecognize the deferred revenue liability in the absence of performance?

In the past, the staff has stated that a vendor should apply the derecognition guidance found in Statement 140¹ to these arrangements, but derecognition may also be acceptable in certain circumstances if the vendor can

demonstrate that it is remote that the customer will require performance.

In a recent registrant matter, the staff addressed breakage for gift cards sold to consumers. Based on historical redemption rates, the registrant determined that some percentage of gift cards sold, for example 10%, would go unredeemed. As a result, each time a gift card was sold, 10% of the value of the gift card was recorded as a credit to the income statement with the remaining 90% value being recorded as deferred revenue.

In this case, the staff objected to the immediate recognition of breakage as we did not believe the delivery criterion had been met. That is, the company believed it was still required to perform under the gift card arrangement, just perhaps not for the full amount of value of the gift card sold. Since there has as of yet been no performance, we did not believe income recognition, in any amount, was appropriate, immediately upon the sale of the gift card.

Given that immediate recognition of breakage was not considered appropriate in this fact pattern, we were asked what approaches may be acceptable. Consistent with the staff's previous views, recognizing gift card breakage as the vendor is legally released from its obligation, for example at redemption or expiration, or at the point redemption becomes remote may both be acceptable methods.

Another approach may be to recognize breakage for unused gift card amounts in proportion to actual gift card redemption. Gift cards sold over a certain period of time would be considered on a homogenous pool basis. The estimated values of gift cards expected to go unused would then be recognized over the period of performance, that is, as the remaining gift card values are redeemed. To utilize this approach, a vendor would be required to not only reasonably and objectively determine the amount of gift card breakage, but also reasonably and objectively determine the estimated time period of actual gift card redemption.

Using my previous example of a 10% breakage rate, assume an entity issues \$1,000 of gift cards in a certain period and has objective evidence to support that those gift cards would be redeemed on a pro-rata basis over the next twenty-four months. The estimated breakage amount of \$100 would, therefore, be recognized ratably over the twenty-four month redemption period.

One final comment. My discussion relates to breakage in a broad sense. However, if you believe your particular circumstances warrant an approach that is unique to the general models covered today, I would encourage you to talk with members from our office.

Customer-Related Intangible Assets

At past conferences, SEC staff members have addressed various issues regarding customer-related intangible assets. I would like to share with you my views related to this topic and discuss some recent practice questions

raised.

Statement 141 requires intangible assets that are acquired in a business combination to be recognized at their estimated fair values². However, questions have arisen about recognition of intangible assets that may not be used to their fullest extent by the acquirer.

It may be best to illustrate this through an example. Company A, which sells apparel products to retail customers, acquires Company B, which sells toy products to those same retail customers. The question is: at what amount the customer relationships of Company B should be recognized, considering the fact that Company A already had relationships with those very same customers, albeit for different product sales?

Some have argued that in this situation, no value should be attributed to these intangible assets since Company A already sold its apparel products to Company B's customer base, and thus already had pre-established relationships with them. However, we have found this argument difficult to accept. Because of the acquisition, Company A now has the ability to sell new products (that is, toy products) to its retail customers that it was unable to sell prior to the acquisition of Company B. And even if the two companies sold competing products to the same retail customers, for instance both sold toy products, the fact that Company A has increased its "shelf space" at each of its customers' retail locations would be indicative of value to those relationships.

We are also aware of other questions regarding what valuation methodology should be used to estimate the fair value of such intangible assets. Although the appropriateness of any valuation technique is highly dependent on individual facts and circumstances, I believe an income approach is generally the most appropriate method for estimating the fair values of customer-related intangible assets. Under this approach, the future benefits of those relationships can be quantified in the form of cash flows expected to be generated from incremental sales to those customers. On the other hand, the use of a cost approach has generally been challenged since, in the staff's experience, the models failed to capture all associated costs that would be necessary to rebuild that customer relationship and the resultant value was not deemed sufficient when compared to values derived by other approaches.

One final point - regarding the inputs to a customer intangible valuation model: There has been much discussion of whether entity-specific or marketplace participant assumptions should be used. Although the proposed amendment to Statement 141³ and the pending standard on fair value measurements⁴ will undoubtedly provide added clarity to this discussion, I believe existing guidance seems to support the use of marketplace participant assumptions when valuing these intangible assets. Both Statement 141⁵, as currently written, and EITF 02-17⁶ state that fair value estimates should incorporate assumptions that marketplace participants would use in making estimates of fair value. I would therefore recommend

consultation with the SEC staff if you are involved in a situation in which you think an entity-specific valuation of an intangible asset is appropriate.

New Basis of Accounting

"New Basis" has been a perennial favorite at these conferences in the past. And although it has been more than a few years since we've talked about new basis at this venue, with the recent uptick in the M&A market, the number of new basis issues addressed by the staff is on the rise. I would like to just touch upon a few issues we have recently addressed.

Application of EITF Topic D-97

The staff issued Topic D-97⁷ nearly five years ago to provide guidance on when a group of investors that participate in a change in ownership transaction should be considered a collaborative group whose ownership should be aggregated in evaluating whether new basis is required. Since its issuance, we are often asked questions about how to apply Topic D-97 and in particular, whether there is any "*new thinking*" by the staff that should be considered in evaluating its criteria. Because the application of Topic D-97 is highly dependent on individual facts, it would be difficult to share any specific examples. However, I would like to remind everyone of the purpose of Topic D-97 and pass along some general observations when applying its provisions.

When a group of investors comes together to make an investment, it is presumed that those investors are working together in concert to promote and collaborate on both the form and subsequent operations of that entity. The factors in Topic D-97 should then be considered to determine whether there is enough evidence to overcome that presumption. The staff has no golden rules in applying Topic D-97. Rather, the totality of all of the factors should be evaluated in concluding whether the investors represent a collaborative group. However, the following are some of the questions that the staff may ask in gaining a better understanding of the relationship among the investors, and thus whether a collaborative group exists:

*How did the various investors come together to make this investment?

*Hypothetically, if one of the investors would have backed out of the deal, would the deal still have been done?

*How are board seats determined and can the number of seats change over time?

*What is the nature of decisions that require unanimous or majority approval of the investors?

*And lastly, what evidence supports that sale restrictions are considered reasonable and customary?

Determining the Appropriate Accounting Models

SEC staff members also address many questions as to when new basis should be applied. The staff's push-down guidance in SAB 54⁸, along with Topic D-97, Statement 141 and EITF 88-16⁹ are the primary pieces of literature that are typically considered when a change in ownership takes place. While determination of the appropriate accounting is highly dependent on the form of the transaction, as I will discuss in a minute or two, perhaps the first question to ask is whose accounting am I addressing? Am I addressing the accounting for an existing operating company (often referred to as OLDCO) which underwent a change in ownership or am I addressing the accounting for a newly formed entity (or NEWCO) which just acquired an operating company? The answer to these questions may help in determining the guidance that should be applied.

To return to Topic D-97: As a reminder, Topic D-97 is an extension of the staff's push-down guidance included in SAB 54. SAB 54 addresses whether the basis of an OLDCO should be adjusted as a result of its change in ownership. Both SAB 54 and Topic D-97 are, therefore, applied from the perspective of the OLDCO. As such, the staff believes it would not be acceptable to apply the push-down rules, including Topic D-97, to entities other than existing or ongoing businesses that undergo changes in ownership.

In a recent example, a business that was previously owned by a group of investors was acquired for cash by a newly formed entity. The NEWCO, which was infused with both cash and debt, was owned by a new group of unrelated investors. The registrant concluded that new basis was not appropriate because, both before and after the transaction, no one single shareholder or collaborative group controlled the entity. The registrant argued that it should "look through" the newly formed entity and consider whether the new investors of NEWCO were a collaborative group in determining if new basis was required. In this fact pattern, we did not consider Topic D-97 to be relevant. Because the entity whose accounting was being considered was NEWCO rather than OLDCO, we did not believe the issue was one of determining whether push-down accounting was applicable.

Continuing on with this same example, the question then becomes what guidance should apply? Since this transaction was not highly leveraged and, therefore, not within the scope of EITF 88-16, the staff concluded that Statement 141 was relevant. NEWCO was considered the accounting acquirer since it was deemed substantive; it acquired a single operating company for cash; and the entire ownership of the operating company had changed. As a result, the acquisition of the operating company resulted in full step-up in basis.

In another example in which a NEWCO was used and the transaction was in fact highly leveraged, the registrant argued that EITF 88-16 was applicable. However, the form of the transaction differed from the leveraged buy-out

transaction described in that literature. In this particular deal, NEWCO did not acquire the stock of the operating company, but rather merged into the operating company as part of a series of related transactions. Thus, the staff objected to the application of EITF 88-16 since the deal's form did not meet the stringent scope requirements of that guidance.

In summary, in both of my new basis examples, the role of NEWCO, the amount of debt, and the form of the transactions were crucial in determining the appropriate accounting.

Although my comments today obviously do not provide answers to all of the new basis questions out there, I hope I was able to illustrate some of the difficulties in applying the new basis guidance. As with all areas of judgmental accounting, we would encourage that companies and their auditors continue to talk to us.

Conclusion

That concludes my prepared remarks, thank you for your time.

Endnotes

- ¹ Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (Statement 140), paragraph 16.
- ² Statement of Financial Accounting Standards No. 141, *Business Combinations* (Statement 141), paragraphs 37 and 39.
- ³ Proposed Statement of Financial Accounting Standards, *Business Combinations-a replacement of FASB Statement No. 141*.
- ⁴ Proposed Statement of Financial Accounting Standards, *Fair Value Measurements*.
- ⁵ Statement 141, paragraph B174.
- ⁶ Emerging Issues Task Force Issue No. 02-17, *Recognition of Customer Relationship Intangible Assets Acquired in a Business Combination*, paragraph 6.
- ⁷ Emerging Issues Task Force Topic No. D-97, *Push-Down Accounting*.
- ⁸ Staff Accounting Bulletin, Topic 5-J, *Push Down Basis of Accounting Required in Certain Limited Circumstances*.
- ⁹ Emerging Issues Task Force Issue No. 88-16, *Basis in Leveraged Buyout Transactions*.

<http://www.sec.gov/news/speech/spch120505jmb.htm>

