U.S. Securities and Exchange Commission

Speech by SEC Staff: Remarks Before the 2006 AICPA National Conference on Current SEC and PCAOB Developments

by

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Introduction

Thank you and good afternoon. During this session, my colleagues and I will share our views on a number of specific accounting, auditing and financial reporting issues. While some of the issues we will discuss truly are black and white applications of specific standards or regulations, it is clear that GAAP does not and cannot always provide definitive guidance on every matter. If it did, I suppose a fair question to ask would be, why are we all here today?

Why are we here today then? It is clear an underlying reason why we gather at this conference year after year is to share our experiences in applying judgment to complex or novel accounting and reporting matters. True, over the past few years OCA has consistently stated that one root cause of complexity in financial reporting is the use of bright lines and exceptions to principles. We will leave suggested standard setting improvements to the preparer and user community. Rather, I will focus on the use of judgment in financial reporting in our present environment.

To that end, many of the experiences we will share with you today were specifically selected to highlight situations where the use of professional judgment impacted the development and presentation of high quality, informative and transparent financial reporting information.

While we listen to the presentations I encourage you to think not only narrowly about the specific issues but also broadly about how the application of judgment is, was or should be incorporated. If you miss any of it, don't worry as we will have transcripts of our speeches posted on our website, hopefully by the end of the conference.

Materiality and SAB 108[1]

The first item I would like to address today involves the application of SAB 108.

SAB 108 was issued to address diversity in practice with regards to the quantification of errors that arose in prior years. I believe by now most of you understand the SAB's objective is to provide a platform to harmonize the quantification of prior period errors considered in the SAB 99 analysis. Therefore, my comments on the SAB itself will be limited. First, the SAB in no way modifies our interpretation of SAB 99, which discusses materiality in a broader sense. Nor is it intended to be a free pass to clean up balance sheets. However, many auditors and registrants have approached OCA with certain questions relating to immaterial errors that we believe may actually best be left to the registrants' and auditors' own judgment. For example:

In the first year of application, can prior year errors that are determined to be immaterial after being quantified under the SAB 108 approach be included in a beginning of the year cumulative effect adjustment?

Although not directly on point, SAB Topic 5F indicates that accounting changes not retroactively applied due to immateriality can be effectuated either by retroactive adjustment of prior period financial statements or in the current statement of income if the correction is immaterial to that period. Practically, registrants typically elect to correct immaterial errors in current period income.

However, what may not be clear is whether those particular immaterial errors would be considered material in the aggregate under SAB 99. If the registrant and the auditors determine that the immaterial error, when aggregated with other material or immaterial errors, is material, then inclusion in the cumulative effect adjustment may be appropriate. Of course, the registrant would still need to disclose each and every error and, by virtue of using the cumulative effect mechanism, would be asserting that the errors are material, at least in the aggregate.

Another question we have received is as follows:

If a registrant elects to retroactively adjust prior period financial statements for immaterial errors, are those financial statements required to be labeled as restated with mention in the auditor's report, and, is the filing of an Item 4.02 8-K required?

This question is more subjective and there is limited guidance that serves as a foundation. However, if you consider that immaterial errors by definition are errors that are believed not to effect the decisions made by current and past investors, then the registrant, in conjunction with its legal counsel and auditors, could make a reasoned judgment about whether each or any of those communications are required or would provide useful information to the financial statement users. It seems the real question is how to meet the objective of clear and transparent financial reporting by providing sufficient disclosure of the changes and the reasons why the changes are necessary.

Application of FIN 46R

I'll move onto consolidation practices we have become aware of that involve FIN 46R.

We understand that certain general partner (GP) / limited partner (LP) arrangements have become common in which the partnership might be considered a variable interest entity (VIE).

These circumstances include a GP that makes no or only a non-substantive investment in the entity. Further, the LPs have no kick-out rights,[2] however, at least one of the LPs are related parties[3] of the GP.

When the GP considers its relationship with the entity in isolation, it comes to the conclusion that the entity is a VIE because the holders of the equity investment at risk as a group, i.e. the LPs, do not have the ability to make decisions about the entity's activities that have a significant effect on its success.[4] A subsequent primary beneficiary determination could conclude that the GP does not absorb greater than 50% of the expected gains and losses and therefore the GP does not consolidate the VIE.

However, a view that analyzes the GP and the entity in isolation seems to be incomplete because of the relationships with certain of the LP investors. Depending on the significance of those relationships, I believe the GP and LPs may be so closely associated that it is most appropriate to consider their interests in the aggregate. This analysis depends heavily on the particular facts and circumstances, thus a degree of reasonable judgment is necessary.

If the GP and LP are considered a group, the FIN 46R analysis could yield different results. If the GP and certain LP equity interests are combined, then the entity, all other things being equal, would likely pass the paragraph 5b(1) test. That is, the equity holders as a group, inclusive of the GP rights, would have the ability to make decisions about the entity's activities that affect its success. The result would be the entity is not a VIE and the accounting consideration would revert to the voting interest model with the GP consolidating.

We understand that some of these structures may have been designed specifically to circumvent EITF 04-5, which would generally result in

consolidation by the GP if the partnership is not a VIE. This gives me a chance to make the point that using professional judgment is not a cover or license to engineer around the intent of accounting literature. Frankly, it's attempts like this that often lead to restatements and more accounting standards as the standard setters seek to close the door on abusive transactions. I do not like complex standards any more than you. With more restatements and complex standards, no one is a winner, investors, preparers and auditors alike.

Professional Judgment in Accounting Decisions

I would like to wrap up our session with a broad discussion on the use of judgment in accounting decisions. We all know that piling standard upon standard to mitigate abuse is a futile effort because accounting standards are not and cannot be written to address every accounting dilemma. And so, we gather at conferences such as this to share our views on the judgments we apply everyday. I believe we all need to differentiate between matters that are black and white and those that require us to use, and just as important, to accept judgment as a necessary aspect of preparing, auditing and understanding high quality financial statements.

I think I know what you're thinking. Did he say accept judgment? That sounds very nice, but what is the point if my judgment will ultimately only be second guessed?

I would be living in a fantasy land if I asserted that this is not a legitimate concern and is precisely why my concluding thoughts are intended to address registrants, auditors and yes, regulators in equal proportions. I hope some of our selected examples provided at least some clarity to that notion.

If not, let's rewind and highlight a few excerpts from what we have heard.

First, recall Joe McGrath's discussion on fair value and inventory. In his remarks, Joe noted that only in exceptional cases may inventories be properly stated above cost and it must meet three specific criteria in ARB 43. Some registrants agreed with Meatloaf and assert, "two out of three ain't bad" and therefore concluded fair value was appropriate. In this circumstance, we do not believe an appropriate use of judgment includes ignoring existing rules. That is better referred to as a simple misapplication of GAAP.

On the other hand, Joe Ucuzoglu raised an example relating to special classes of stock granted to employees. In this situation, there are no rules to determine exactly which awards are equity and which are liabilities. But by considering all of the relevant information about the awards it should be possible to figure out if they truly are more akin to equity based or cash-settled forms of compensation. Although this kind of judgment call could make people nervous about whether their judgment will be accepted, a process that considers, assesses, and documents all of the relevant facts and conclusions, and discloses that conclusion when material should significantly

mitigate the risk of so called second guessing.

This notion of judgment extends beyond accounting to areas such as auditor independence. For example, Michael Husich highlighted the requirement for audit committee discussions regarding relationships that may be reasonably thought to have an impact on the auditor's independence. The rule requires a mechanism ensuring violations are reported to the audit committee, but the intent of the rule is to facilitate frank discussions on matters that could impact auditor independence. Care should be taken to ensure that judgment does not evolve into an annual rubber stamp event and the process should be transparent as to what was discussed and decided.

Finally, we in OCA understand that judgment is an inherent aspect of financial reporting. There is no question that in some circumstances, two people may reach differing conclusions to similar fact patterns. Practically then, some registrants appreciate the opportunity to reach out to OCA and pre-clear their more complex judgments. Admittedly, the registrants might not always appreciate our view. In any case, and if you are not already aware, I would like to point out that our portion of the SEC website[5] includes a protocol that registrants can use to pre-clear the issues that they and their auditors feel are significantly judgmental.

I encourage you to visit our website and peruse the discussion that lays out the specific protocol. It's safe to say a pre-filing submission to OCA may be a more convenient process then an after the fact review by other Divisions of the Commission.

This concludes our presentation this afternoon. We know you are busy and appreciate your time to listen to and consider the thoughts we have laid out today and look forward to your questions.

Endnotes

[1]SAB 108 can be found using the following link: http://www.sec.gov/interps/account.shtml

[2]Refer to EITF 04-05 and FIN 46R paragraph B20 for a discussion on GP and LP rights kick-out arrangements.

[3]Related party in this context is defined by paragraph 16 of FIN 46R and paragraph 24 of SFAS 57.

[4]FIN 46R paragraph 5b.

[5]The formal protocol guidance for consulting with the Office of the Chief Accountant can be found at: http://www.sec.gov/info/accountants/ocasubguidance.htm

http://www.sec.gov/news/speech/2006/spch121106mm.htm

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