



U.S. Securities and Exchange Commission

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

by

Joseph B. Ucuzoglu

*Professional Accounting Fellow
Office of the Chief Accountant
U.S. Securities and Exchange Commission*

Washington, D.C.
December 11, 2006

The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues upon the staff of the Commission.

Introduction

Good afternoon. I will begin today with the topic of purchase price allocations, focusing my remarks on unfavorable revenue contracts and customer relationship intangible assets.

Purchase Price Allocations (Unfavorable Revenue Contracts)

At the date of a business combination, the terms of an acquired entity's in-process revenue contracts may be less favorable than the terms that could be realized in a current market transaction. In that circumstance, Statement 141¹ may require an unfavorable contract liability to be recognized such that the rate of return reflected in the post-acquisition financial statements of the acquirer is equal to a market return for the acquirer's remaining performance effort.

One would generally expect that the contract terms originally negotiated between the acquired entity and its customer represented a market rate of return at the date the contract was entered into, because the transaction was consummated by a willing buyer and willing seller. Accordingly, an analysis of whether a contract is unfavorable at the acquisition date would usually focus

on the intervening events and changes in circumstances that occurred during the period between contract consummation and the date of the acquisition. Absent intervening events or changes in circumstances, the staff can be expected to raise concerns about an assertion that an acquired contract was in an unfavorable position. Importantly, when determining the current market rate of return for a similar contract, the assumptions utilized should reflect the amount at which an actual transaction could be consummated in a competitive bidding environment, not the list price that a vendor would use as a starting point in contract negotiations.

Purchase Price Allocations (Customer Relationship Intangible Assets)

The fact that the acquired entity has a contractual relationship with the customer may also give rise to a valuable customer relationship which must be considered in the purchase price allocation pursuant to Statement 141.² This provides a nice segue into my next topic. The issue of valuing customer relationship intangible assets seems to have become an annual topic at the SEC conference.

Some have suggested that the SEC staff always requires the use of an income approach to value customer relationship intangible assets. The staff has even heard some suggest that, as long as a registrant characterizes its valuation method as an income approach, the specific assumptions used or results obtained will not be challenged by the staff, because one has complied with a perceived bright line requirement to use an income approach. Let me assure you, these statements are simply false. While an income approach often provides the most appropriate valuation of acquired customer relationship intangible assets, circumstances may certainly indicate that a different method provides a better estimate of fair value. On the flipside, even when a registrant concludes that an income approach is the most appropriate valuation methodology, the staff may nevertheless question the result obtained when the underlying assumptions, such as contributory asset charges, do not appear reasonable in light of the circumstances.

When determining the appropriate valuation of a customer relationship intangible asset, I believe that the first step in the process should be to obtain a thorough understanding of the value drivers in the acquired entity. That is, why is it that customers continually return to purchase products or services from the acquired entity? In some cases, the nature of the relationship may be such that customers are naturally "sticky," and tend to stay with the same vendor over time without frequently reconsidering their purchasing decisions. In that circumstance, it would appear that a significant portion of the ongoing cash flows that the acquired entity will generate can be attributed to the strength of its customer relationships.

At the other end of the spectrum, relationships may be a less significant value driver in an environment where customers frequently reassess their purchasing decisions and can easily switch to another vendor with a lower price or a superior product. In that environment, if customers continually return to buy products from the acquired entity, perhaps they do so in large

part due to factors other than the relationship, such as a well-known tradename, strong brands, and proprietary technologies. As a result, the value of the customer relationship intangible asset may be less than would be the case in a circumstance where the relationship is stronger. However, the staff would generally expect that the amount attributed to other intangible assets would be commensurately higher, reflecting the increasingly important role of those assets in generating cash flows.

Option Grants with Administrative Delays

I would now like to provide a few thoughts on stock option granting practices. My remarks today are not focused on the past, but rather on considerations for the future. It is now quite clear that there were a wide range of stock option granting practices in use by companies. Many companies have found that their historical practices were designed to grant in-the-money options to employees while creating the appearance that such grants were in fact at-the-money. On the other hand, some companies have found that their option granting practices were designed to grant at-the-money options, but there were delays in the completion of administrative procedures to document the grants that did not involve misrepresentation of the option granting actions. With respect to this second group, our September 19, 2006 stock option letter³ discusses the staff's view that it may have been possible to reach a measurement date under Opinion 25⁴ in advance of completing all of the administrative procedures necessary to effect the grant of a stock option. Opinion 25 required only that the terms and recipient of the option were "known," without describing in detail which governance procedures must be completed in order to reach a measurement date.

The staff has now been informed that some companies continue to grant options pursuant to processes that almost ensure that all required corporate governance procedures will not be complete by the date that the company uses to set the exercise price of the option, and questions have arisen with respect to the impact of administrative delays on the determination of the grant date of an award under Statement 123R.⁵ Unlike Opinion 25, Statement 123R is quite clear on the importance of completing certain corporate governance procedures when determining whether a grant date has occurred. When an option is subject to approval by the Board of Directors, Statement 123R states that a grant date is not reached until that approval is obtained. Accordingly, certain granting practices that did not delay the measurement date under Opinion 25 may in fact delay the grant date under Statement 123R.

The staff notes that these accounting questions rarely arise when a company grants options pursuant to a well-controlled process. In light of the recent events surrounding past stock option grants, the staff believes it would be prudent for companies to revisit their stock option granting processes and ensure such processes are in full compliance with the company's corporate governance provisions, the terms of its stock option plans, and all applicable laws. Given the risks associated with the options granting process that have

become all too clear in recent months, companies may need to pay additional attention to their internal controls in this area.

Special Classes of Stock Granted to Employees

I'll now move on to a slightly different type of stock-based compensation. The staff has observed the increasing use by both public companies and pre-IPO companies of special classes of stock that are granted only to employees.

Public companies often create special classes of stock to more closely align the compensation of an employee with the operating performance of a portion of the business with which he or she has oversight responsibility. That is, rather than granting an equity interest in the parent company, employees are granted instruments whose value is based predominantly on the operations of a particular subset of the parent's operations. The staff has observed the use of these arrangements in diverse industries, ranging from the grant of an interest in a group of restaurants that an employee oversees, to the grant of an interest in a particular investment fund that an employee manages.

Similarly, pre-IPO companies often create special classes of stock to provide employees with an opportunity to participate in any appreciation realized through a future initial public offering or sale of the company, with limited opportunity for gain if no liquidity event occurs. In order to accomplish this objective, the special class is often subordinate in both dividend rights and liquidation preference to the company's main class of stock, and may have little or no claim to the underlying net assets of the company. In many cases, the terms of these instruments mandate conversion into the entity's main class of common stock upon the completion of an IPO.

Several accounting issues arise when a special class of stock is granted to employees. First and foremost, one must look through the legal form of the instrument to determine whether the instrument is in fact a substantive class of equity for accounting purposes, or is instead similar to a performance bonus or profit sharing arrangement. When making this determination, all relevant features of the special class must be considered. There are no bright lines or litmus tests. When few if any assets underlie the special class, or the holder's claim to those assets is heavily subordinated, the arrangement often has characteristics of a performance bonus or profit-sharing arrangement. Instruments that provide the holder with substantive voting rights and *pari passu* dividend rights are at times indicative of an equity interest. Consideration should also be given to any investment required, and any put and call rights that may limit the employee's downside risk or provide for cash settlement. Many of these factors were contained in Issues 28 and 40 of EITF Issue 00-23,⁶ which provided guidance on the accounting under Opinion 25 for certain of these arrangements.

When the substance of the instrument is that of a performance bonus or profit sharing arrangement, it should be accounted for as such. In those circumstances, any returns to the employee should be reflected as

compensation expense, not as equity distributions or minority interest expense. Further, if the employee remitted consideration at the outset of the arrangement in exchange for the instrument, such consideration should generally be reflected in the balance sheet as a deposit liability.

On the other hand, when the substance of the arrangement is in fact that of a substantive class of equity, questions often arise as to the appropriate valuation of the instrument for the purpose of recording compensation expense pursuant to FASB Statement No. 123R.⁷ These instruments, by design, often derive all or substantially all of their value from the right to participate in future share price appreciation or profits. Accordingly, the staff has rejected the use of valuation methodologies that focus predominantly on the amount that would be realized by the holder in a current liquidation, as such an approach fails to capture the substantial upside potential of the security.

In addition, it is important to note that even when such instruments are considered a substantive class of equity for accounting purposes, the terms of these instruments often result in a requirement to classify the instruments outside of permanent equity in the balance sheet pursuant to EITF Topic D-98⁸ and to present earnings per share in accordance with the two-class method pursuant to EITF Issue 03-6.⁹

Postretirement Benefit Plan Amendments

Transitioning the discussion from stock-based compensation to another form of compensation, many companies are enacting changes to their pension and postretirement benefit plans in an effort to reduce their obligations and mitigate their risks with respect to these arrangements. The staff has observed that these benefit plan changes often consist of a series of interrelated actions in which the benefits offered under certain of the employer's arrangements are reduced or eliminated, while the benefits offered under other arrangements are enhanced. If the liability for each of the employer's arrangements was reflected in the financial statements at fair value, with any changes during the period immediately recognized in income, the increases and decreases to various benefit arrangements would naturally offset such that the net amount reflected in the income statement would represent the true economic reduction in the employer's benefit obligations. Unfortunately, the deferred recognition provisions of Statements 87¹⁰ and 106¹¹ result in the recognition of certain plan changes over a future period, while changes to certain other benefit arrangements are reflected in income immediately.

In order to appropriately reflect the economic substance of a series of interrelated benefit plan changes, it is important to consider the totality of the actions taken. As a simple example, a company may reach an agreement with its employees to forgo paying a presently due bonus that the employees have earned, and in return will increase the benefits payable under its pension plan by an equal amount. If one were to view the two actions in isolation, the elimination of the bonus accrual would be reflected as a gain in

the income statement immediately, while the benefit enhancement in the pension plan would be reflected as prior service cost and amortized over a future period. That accounting would not reflect the underlying economic substance of the exchange.

The FASB Staff Implementation Guides to Statements 87, 88 and 106 contain several examples that may assist preparers in determining the appropriate accounting for concurrently negotiated changes in various benefit plans. Consistent with that guidance, in some circumstances, it may be most appropriate to immediately recognize in income part or all of the change in the obligation under a defined benefit plan rather than reflecting such change as a positive or negative plan amendment that is amortized into income over future periods.

The determination of the appropriate accounting for concurrently negotiated benefit plan amendments will also depend in part on the characterization of each affected plan as a defined contribution or defined benefit plan. The staff has observed circumstances in which the benefits in a pre-existing defined benefit plan may be reduced or eliminated, in exchange for the creation of a new plan to which the employer will make fixed contributions. Statements 87¹² and 106¹³ are clear that a plan shall be considered a defined contribution plan only if several criteria are satisfied, one of which is the existence of an individual account for each participant. Any plan that does not meet the definition of a defined contribution plan is considered a defined benefit plan. In the arrangements brought to the staff, even though the employer was at risk only for the amounts contributed to the new plan, the absence of individual participant accounts resulted in a conclusion that the new plan should be accounted for as a defined benefit plan.

While on the topic of pensions, I do want to mention one important development in the regulatory environment. The recently enacted Pension Protection Act of 2006 may materially impact a company's funding obligations with respect to its benefit plans. Consistent with FRR 72,¹⁴ registrants should provide transparent disclosure in Management's Discussion & Analysis of the Act's anticipated impact on the company's liquidity and capital resources. Although in some circumstances it will be difficult to forecast precise funding requirements due to the annual recomputation required by the Act, it will often be possible to provide disclosure of the magnitude of cash commitments for future annual periods assuming present market conditions remain constant.

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

Endnotes

¹Statement of Financial Accounting Standards No. 141, Business Combinations, paragraph 37(c)(2)

²Statement of Financial Accounting Standards No. 141, Business Combinations, paragraph A14(b)

³Letter from Chief Accountant to Lawrence Salva, Chairman, Committee on Corporate Reporting, Financial Executives International and Sam Ranzilla, Chairman, Center for Public Company Audit Firms, American Institute of Certified Public Accountants concerning accounting for stock options in the historical financial statements of public companies (September 19, 2006)

⁴APB Opinion No. 25, Accounting for Stock Issued to Employees, paragraph 10 (b)

⁵FASB Statement No. 123R, Share-Based Payment, paragraph E1

⁶EITF Issue No. 00-23, Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44, Issues 28(a) and 40(b)

⁷FASB Statement No. 123R, Share-Based Payment, paragraph 7

⁸EITF Topic No. D-98, Classification and Measurement of Redeemable Securities

⁹EITF Issue 03-6, Participating Securities and the Two-Class Method under FASV Statement No. 128

¹⁰FASB Statement No. 87, Employers' Accounting for Pensions, paragraph 24

¹¹FASB Statement No. 106, Employers' Accounting for Postretirement Benefits other than Pensions, paragraph 51

¹²FASB Statement No. 87, Employers' Accounting for Pensions, Appendix D

¹³FASB Statement No. 106, Employers' Accounting for Postretirement Benefits other than Pensions, paragraph 518

¹⁴Financial Reporting Release No. 72, Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations

<http://www.sec.gov/news/speech/2006/spch121106jbu.htm>