

intangible asset amortization; and reseller rebates. The issues include determining whether an arrangement should be recorded gross or net and whether it should be recorded as revenue or a reduction of an expense.

The SEC staff acknowledged that the guidance on income statement geography is piecemeal and contained in several different areas of the accounting literature. In addition, in some cases (e.g., research and development reimbursements), a company may be able to support more than one conclusion based on the existing accounting literature. The SEC staff emphasized that companies should evaluate the facts and circumstances of each arrangement, consistently apply reasonable judgment (e.g., refrain from cherry-picking to get a desired result), and disclose the method of accounting used, as well as disclose the reason(s) that the chosen method is appropriate.

## Segments and Reporting Units

The proper identification of segments and reporting units continues to be an area of focus for the SEC staff. The importance of the issue is twofold: (1) the proper identification of operating segments and the potential aggregation of operating segments into reportable segments impacts footnote disclosures in the financial statements and (2) the proper identification of operating segments is essential to the registrant's proper identification of reporting units for purposes of allocating goodwill and for goodwill impairment analyses under FAS 142, *Goodwill and Other Intangible Assets*. The SEC staff raised the following points:

- Stringent conditions should be met in order to aggregate multiple operating segments into a reportable segment. Only those operating segments with similar characteristics (e.g., gross margin, nature of products, and class of customers) should be aggregated. Such operating segments are aggregated only because separate reporting of this segment information will not significantly improve an investor's understanding of the company.
- A component of an operating segment can be aggregated only with other components of the same operating segment (provided that the components have similar economic

characteristics) for purposes of determining a reporting unit under FAS 142. A component of one operating segment cannot be aggregated with a component of a different operating segment, regardless of whether the components have similar economic characteristics.

- There is a presumption that the information received is also used by the chief operating decision maker.

## PCAOB Update

George Diacont, Director of the PCAOB's Division of Registration and Inspections, reported that the inspections staff now has about twenty AS 2 experts. He stated that in the inspections for the upcoming year, the staff will be looking for evidence of increased efficiency through the prism of the recommendations made in the PCAOB's May 16, 2005 guidance and November 30, 2005 report. Those recommendations include that audit firms achieve better integration of the audit; use a top-down/risk-based approach; leverage the work of others; and alter the nature, timing, and extent of tests.

Audit areas where PCAOB inspectors find repeat issues include documentation and the setting of expectations when performing analytical procedures, auditing of estimates, evaluation of the qualification of specialists, and the confirmation process. Inspection teams will continue to focus on these areas.

## PricewaterhouseCoopers Contacts

For more information about the subject of this *QuickBrief*, please contact:

John G. Maxwell	973-236-4780
Americas Retail & Consumer Industry Leader	
Nadia Alaudini	513-361-8185
Americas Retail & Consumer Industry Partner	
Steven J. Barr	585-231-6190
Americas Retail & Consumer Industry Partner	

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# QuickBrief!

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## What We Heard at the SEC Conference

The 2005 AICPA National Conference on Current SEC and PCAOB Developments was held on December 5, 6, and 7, 2005. At the Conference, members of the Staff of the Securities and Exchange Commission (SEC or the SEC staff), the Financial Accounting Standards Board (FASB), the American Institute of Certified Public Accountants (AICPA), the International Accounting Standards Board (IASB), and the Public Company Accounting Oversight Board (PCAOB) expressed their views on a variety of technical accounting and other matters.

The following highlights certain matters from the Conference that you will find of interest during the 2005 annual report/10-K preparation and review process and in keeping abreast of current developments. This summary is not intended to be a comprehensive outline of the SEC Conference. For more coverage, our document, Dataline 2005-49, *Highlights of the 2005 AICPA National Conference on Current SEC and PCAOB Developments*, is available on [www.cfodirect.com](http://www.cfodirect.com).

### Management's Discussion and Analysis (MD&A)

A number of Conference participants shared their views regarding the critical role that MD&A of a company's financial condition and results of operations plays in financial reporting. Speakers emphasized that MD&A should be considered a mechanism for communicating to investors and the capital markets a clear view of management's perspective of the company and its strategy, with a focus on:

- Value drivers
- Market opportunities and threats
- Key performance indicators, including non-financial metrics
- Risks and uncertainties
- Forward-looking information
- Liquidity prospects

The SEC staff noted a number of areas where companies and their advisors should continue to focus their efforts in order to enhance the quality and usefulness of MD&A, including disclosures about:

- Critical accounting policies and estimates (disclosures should emphasize key judgments and sensitivities and describe how they might change in the future)
- Revenue recognition and interrelationships among price, volume, mix, and other pertinent factors
- Restructuring activities and impairments
- Pensions and other postretirement benefit plans
- The impact that items discussed throughout MD&A have on the company's liquidity

The SEC staff also noted that the key terms of material settlements and cash flows related to discontinued operations should be discussed in the "liquidity and capital resources" section.

### Quantification of Unadjusted Errors

The SEC staff discussed the longstanding debate on the use of the "rollover" method versus the "iron curtain" method for quantifying unadjusted errors. The SEC staff reiterated its belief that diversity in practice in an area as basic as quantifying errors is not appropriate. Although the SEC staff continues to consider ways to resolve this issue, the SEC staff stated that its ultimate goal is to move registrants to a common approach without requiring restatements when a previously acceptable approach was properly applied. The SEC staff acknowledged the need to allow adequate time for registrants to digest any new guidance and said that some form of guidance will likely be needed to help registrants that are adopting a new quantification approach for the first time. The SEC staff reiterated its 2004 suggestion that unadjusted errors should be quantified using both the "rollover"

and “iron curtain” methods (sometimes referred to as a dual approach). The SEC staff suggested that pending the release of any new guidance, registrants should focus on (1) reviewing internal policies to ensure a consistent approach to quantifying errors (e.g., if the registrant has a decentralized structure, the registrant should consider whether error quantification is being applied consistently throughout the organization) and (2) giving appropriate consideration to the impact of errors on future periods when assessing materiality.

Formal guidance on the topic of the quantification of unadjusted errors was expected during 2005. At the Conference, however, the SEC staff said that it continues to work on the issue and did not specify a timeframe in which the guidance will be completed.

### Statement of Cash Flows

The statement of cash flows continues to be an area of significant focus for the SEC staff. The SEC staff recommended that registrants take a “fresh look” at the statement of cash flows, in its entirety, including routine and non-routine transactions. The SEC staff specifically discussed the statement of cash flows in terms of the presentation of discontinued operations.

The SEC staff remarked that discontinued operations are being reported in increasing numbers under FAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, but observed that there is diversity in practice regarding the presentation of discontinued operations in the statement of cash flows. FAS 144 permits a company to distinguish a discontinued component’s cash flows from its ongoing operations. The SEC staff noted, however, that FAS 144 does not amend FAS 95, *Statement of Cash Flows*.

FAS 95, footnote 10, states that cash flows related to discontinued operations need not be disclosed separately as operating, investing, and financing activities; however, if a company does report such cash flows separately, it should do so consistently for all affected periods. The SEC staff cautioned that FAS 95 does not support either (1) aggregating, into a single line item in the statement of cash flows, the various cash flows that resulted from operating, investing, and financing activities associated with discontinued operations or (2) presenting within the single category of “operating cash flows” all the operating, investing, and financing cash flows that resulted from discontinued operations. See DataLine 2005-49 for examples of acceptable presentation of discontinued operations in the statement of cash flows.

### Stock-Based Compensation

During the Conference, the FASB staff described the role of the FAS 123(R) Resource Group (the Group). Several implementation issues related to FAS 123(R), *Share Based Payment*, have been discussed by the Group, which consists of individuals from accounting firms, the preparer community, benefits consulting firms, and the FASB staff, as well as observers from the SEC and PCAOB staff. The Group’s objective is to identify potential implementation issues arising from FAS 123(R), discuss those issues, reach a consensus (if possible), and bring to the FASB’s attention issues that the Group cannot resolve. Although the FASB staff emphasized that a Group consensus does not represent authoritative guidance, it encouraged Conference participants to obtain the minutes of the Group’s meetings from a Group member. Additionally, the FASB staff stated that it would not expect diversity in practice to develop with regard to a particular issue if the Group was able to reach a consensus on that issue.

The FASB staff summarized the consensus that the Group reached on the following issues.

- *Pro Forma Balance Sheet Amounts:* Companies that capitalized compensation cost in their FAS 123 pro forma footnote should decide, as an accounting policy, either to (1) recognize the pro forma amounts in the balance sheet as a cumulative effect upon adoption of FAS 123(R) or (2) make no adjustments to the opening balance sheet, and subsequently begin capitalizing compensation cost after the adoption of FAS 123(R). Companies that did not capitalize compensation cost in their pro forma footnote disclosures under FAS 123 should begin capitalizing compensation cost after the adoption of FAS 123(R). Companies should disclose their accounting treatment of pro forma balance sheet amounts. (See Issue No. 8 of DataLine 2005-24, *Consensuses Reached by the FAS 123(R) Resource Group*, for further discussion of this issue.)
- *Interim Period Tax Effects:* Tax deficiencies (or shortfalls) and windfall tax benefits should not be anticipated for interim reporting purposes. Additionally, shortfalls that are realized early in the year should be offset by windfall tax benefits that are realized later in the same fiscal year. (See paragraph 5, Issue No. 8, of DataLine 2005-32, *Consensuses Reached at the July 21, 2005 FAS 123(R) Resource Group Meeting*, for further discussion of this issue.)

The SEC staff also addressed FAS 123(R) implementation matters, specifically discussing the guidance in SAB 107, *Share-Based Payment*, emphasizing that the implementation of FAS

123(R) will require companies to use “reasonable” judgment and make “good faith” estimates. The SEC staff further remarked that if companies use good faith estimates, the staff will not view changes in an award’s value after its grant date as calling into question the reasonableness of the grant date fair value estimate.

In SAB 107, the SEC staff acknowledged that a range of potential methodologies and conclusions could be reasonable when the fair value of a stock-based compensation award is being estimated, particularly in the initial years of FAS 123(R)’s implementation. Companies should support their good faith estimates by documenting in detail the basis for their estimates and by including in their financial statements robust disclosure of the methods and assumptions that were used to estimate the fair value of stock-based compensation awards.

## Business Combinations

### *Customer-Related Intangible Assets*

The SEC staff discussed the following issues related to the recognition and valuation of customer-related intangible assets:

- When valuing customer-related intangible assets, current accounting literature, including FAS 141, *Business Combinations*, provides that estimates of fair value should normally incorporate assumptions that marketplace participants would apply, rather than entity-specific assumptions. The SEC staff recommends consultation when a registrant believes that it is more appropriate to apply entity-specific assumptions to the valuation of an intangible asset.
- The use of the income approach, whereby the expected incremental cash flow from sales to customers of the acquired company is used to value the relationship, is generally the most appropriate method for estimating the fair value of customer-related intangible assets. It has been the SEC staff’s experience that the replacement cost approach may not capture all of the costs necessary to rebuild customer relationships, and therefore may result in insufficient value allocated to the relationship.
- It is appropriate to recognize a customer-related intangible asset where there is “customer overlap,” or in situations in which both an acquiring company and a target company sell products or services (whether or not the products or services are similar) to the same customer. Although the acquiring company already had a relationship with the customer prior to the acquisition of the target company, the acquiring company can now sell different products or services or increase the volume of business with the existing customer.

## Revenue Recognition

### *Accounting for “Breakage”*

The SEC staff addressed arrangements whereby a customer makes a payment before vendor performance (e.g., purchases a gift card), and the vendor recognizes a deferred revenue liability when the payment is received. In some cases, the customer will not require full performance, often referred to as “breakage” (e.g., some percentage of gift cards sold go unredeemed). There is a question as to the timing of when the vendor should derecognize the deferred revenue liability and recognize revenue associated with a performance obligation that the vendor will not have to fulfill (breakage).

In the past, the SEC staff stated that a vendor should apply the derecognition guidance in FAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. However, the SEC staff acknowledged that earlier derecognition might be acceptable in certain circumstances if the vendor can demonstrate that there is only a remote possibility that the customer will require full performance. The SEC staff emphasized that it would object to the immediate recognition of breakage, because the delivery criterion is not fulfilled. For example, even if 10 percent of gift cards typically go unredeemed, a company should not recognize 10 percent of the value immediately upon the sale of the gift card.

Consistent with the SEC staff’s previous views, the following two methods of recognizing breakage are acceptable:

- When the vendor is legally released from its obligation (i.e., upon redemption or expiration)
- When the likelihood of redemption becomes remote

The SEC staff indicated that another acceptable approach is to recognize the breakage in proportion to the actual redemption. Under this approach, the estimated value of gift cards that are expected to go unused would be recognized over the period that the remaining gift cards are expected to be redeemed. To use this approach, the company will be required to reasonably and objectively estimate the gift card breakage, as well as estimate the period of actual gift card redemption.

Companies should disclose the method used to recognize breakage, including any significant estimates.

### *Income Statement Geography*

The SEC staff noted that, in practice, issues frequently arise from inappropriate income statement classification for several types of transactions: research and development reimbursements; deferred revenue from a business combination; vendor taxes;