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Revenue Recognition a Top SEC Concern in Comment Letters

BY STEVEN MARCY, BNA STAFF EDITOR

The staff of the Securities and Exchange Commission raised revenue recognition questions in more than any other topic in comment letters sent to 8,585 individual registrants since 2004, according to analysis of the letters by AuditAnalytics.com.

Mark Cheffers, CEO of the research firm and an SEC filings specialist, told an American Institute of Certified Public Accountants conference Dec. 12 that the SEC staff raised questions about revenue recognition in letters sent to 27 percent of financial report filers who received letters in that time frame.

The SEC began making public the exchange of correspondence between registered public companies and SEC staff on accounting and disclosure issues in 2005. Cheffers told AICPA's National Conference on Current SEC and PCAOB Developments that his company analyzed the comment letters and he offered a broad overview of that analysis. The 8,585 individual registrants received a total of 28,340 comment letters on failings ranging from 10-Ks to registration filings, Cheffers said. For the purposes of analyzing the accounting issue the SEC questioned and the industries they questioned, AuditAnalytics analyzed only the 5,105 firms whose 10-K filings elicited at least one comment letter since 2004.

''It makes sense that they would look at revenue recognition as a high priority item. It's probably the single most significant area of dispute or manipulation in the financials, at least when it comes to things that matter,'' Cheffers said.

The SEC's focus on revenue recognition also affected which industries received comment letters, he said. ''The SEC looked at companies that have a higher propensity of issues related to revenue recognition, more so than other kinds of filers that don't necessarily have that issue,'' Cheffers said.

Other Problems. According to the AuditAnalytics research, after revenue recognition, the top areas in which the SEC raised questions were:

- segment reporting, with 21 percent of filers that received a comment letter receiving a comment letter on that issue;
- deferred compensation, 20 percent;
- contingencies, 16 percent;
- intangibles, 15 percent;
- receivables, 15 percent;
- options, 14 percent;
- inventory, 12 percent;
- derivatives, 8 percent;
- deferred taxes, 5 percent; and
- inter-company issues, 1 percent.

Industries that were the top six leading recipients of SEC comment letters in order were:

- semiconductors, with 55 percent of the 10-K filers in that industry receiving at least one comment letter;
- pharmaceuticals, 54 percent;
- insurance, 50 percent;
- computer equipment, 47 percent;
- software, 43 percent; and
- construction, 43 percent.

''These are all fairly high revenue recognition industries,'' Cheffers said of the six leading industries.

The lowest six industries receiving at least one SEC comment letter were:

- funds and trusts, 4 percent;
- hotels and motels, 25 percent;
- entertainment, 27 percent;
- financial services, 27 percent;
- health care, 27 percent; and
- restaurants, 30 percent.

Cheffers indicated that the financial hits many financial service companies are taking from value deterioration in the subprime mortgage market will affect their

status of receiving relatively few letters. ''I guess the one industry on the low side was the financial services. That made my eyebrows go up just a little bit,'' he said. ''I'm sure that in the current regime, that that will be corrected relatively soon.''

The number of accounting comment letters the SEC issued from 2004 through October 2007 was more than he expected, Cheffers said, but the volume has abated so far through 2007. The number of comment letters for 2007 declined to 2,571 by early October 2007 after peaking at 4,892 for all of 2006. The 28,340 letters the SEC issued on all types of filings—not just 10-Ks—since it was required by the Sarbanes-Oxley Act to review the financial statements of all of its registrants at least once every three years since 2004 works out to an average of 3.3 per registrant, Cheffers said. Registrants in the same period issued about 25,000 letters in response, he said.

The ''bit lower than norm'' number of registrants who received letters this year might be attributable to the fact that ''this is the second time through'' since SOX mandated the reviews, ''and this may indicate that they are a little more satisfied with the disclosures,'' Cheffers said.

Great Insight. Nonetheless, ''since Sarbanes-Oxley, there's been a much more vibrant communication between the SEC and registrants,'' Cheffers said.

Overall, ''one of the things that you can draw from these numbers simply is that comment letters are becoming much more normalized,'' he said. ''When you receive them, you shouldn't be overly concerned about it. It's part of a normal process.'' He said that up to 34 percent of registrants ''can expect to receive a [SEC comment] letter in any given year.''

The SEC 's comment letters can provide one of the clearest windows into how a company's competitors deal with accounting issues and strategic issues, Cheffers said.

He said that especially for companies in similar industries, the comment letter availability ''gives the reader insight that in some cases is better than reading any standard, law, principle or rule. . . . [P]ractioners should be reading comment letters of their peers. I promise, your professional judgment will be informed.''

Cheffers told reporters after his presentation that he was ''struck by the quality of the discussion'' in the comment letters and the companies' responses. ''You can see the exercise of judgment in these letters'' and not an attempt by the SEC to impose hard rules and accounting bright lines, he said.

E&Y Analysis. Separately, Ernst & Young has also been periodically analyzing comment letters for trends to advise its clients on SEC concerns and how to navigate them. In two separate 2007 reports on SEC comment letters, the latest from September, E&Y spotted many of the same trouble spots as AuditAnalytics.

In its September report, E&Y noted that SEC has focused on Staff Accounting Bulletin 108, which advises how to correct and report mistakes from prior years.

E&Y said SAB 108 resulted in a series of comments ''with regard to its transition,'' which had not been previously analyzed. The transition period has passed on SAB 108.

E&Y also said that ''it is too soon to know what, if any, views and concerns the SEC staff may express'' with regard to implementation of FIN 48, *Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109*. The firm noted that first-time recognition and disclosures under FIN 48 are just occurring for many companies.

Problems with inventory accounting, which bedeviled filers in early 2006 and led to a wave of restatements, continued to draw the attention of the SEC staff, E&Y said, especially when filers use more than one method to determine inventory costs. Eliciting the SEC's attention were filers who use both first-in, first-out accounting and last-in, first-out accounting, or some combination of the two, the firm said.

The SEC took notice ''particularly if the disclosures are overly general and it is not discernible whether more than one method is being used to determine the cost of similar types of inventory,'' E&Y said. ''As a result, the SEC staff has requested registrants to expand their inventory disclosures to include the following:

- which types of inventory are accounted for under each method;
- the carrying amounts of inventory accounted for under each method; and
- whether more than one inventory method is used for similar types of inventory and, if so, why this is the case.''

Questionable Inventory Methods. While E&Y noted that multiple methods for determining inventory costs might be valid in some cases, ''the SEC staff challenges whether registrants have a valid business purpose for using multiple methods. Consequently, a registrant should determine its business rationale for selecting inventory methods, especially if the registrant uses multiple methods for similar types of inventory.''

The SEC also warned that companies that write down the value of inventory should not subsequently revalue it upward, E&Y said. The firm notes that Topic 5.BB, *Inventory Valuation Allowances*, of Staff Accounting Bulletin 100, *Restructuring and Impairment Charges*, ''provides that a write down of inventory establishes a new cost basis that cannot be subsequently marked up. As a consequence, the SEC staff has challenged whether these registrants are effectively marking up inventory in subsequent periods when inventory allowances are reduced or reversed.''

''The SEC staff also has questioned whether the subsequent sale of inventory previously written down resulted in the recognition of gross margins in excess of typical gross margins,'' E&Y said. ''When this is the case, the SEC staff has asked registrants to include appropriate disclosures'' in the management discussion and analysis.''

Hedging Issues. E&Y also said the SEC staff has made it clear that a hedge and hedged item must match nearly exactly so that the value is very close to zero to pass the effectiveness test. The SEC interpreted the Financial Accounting Standards Board's Statement of Financial Accounting Standard 133, *Accounting for Derivative Instruments and Hedging Activities*, as requiring that ''the appropriate level of 'precisions' at which a derivative's cash flows should be viewed as 'exactly matching' a hedged item's cash flows is a single day,'' the firm said. ''That is, an 'exact match' with respect to timing means *the same day*, not an interval more pre-

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cise'' such as an hour, or less precise such as a week or month.

The SEC also found fault with firms who link two or more derivatives to the hedged same cash flow that occurs on the same date but do not identify the derivative in the ''first position'' and the one in the second position. E&Y said many firms thought the identification unnecessary because it was part of ''sound risk management policies that call for diversification of counterparty credit risk and the pursuit of competitive bids. Often the two (or more) derivatives are traded and priced with the different counterparties at the same moment, resulting in identical, or nearly identical, rates.'' Because of this near identicality, most companies thought it unnecessary to separately identify the two positions. But E&Y said the SEC registrants need to think that a portion of the hedged cash flow might at some point be no longer probable of occurring, and the company needs to identify which derivative might be affected by a reduction in probable cash flows.

Stock Options, Cash Flows. The SEC also challenged firms for taking discounts on options and other share-based payments awarded to employees, E&Y said. The SEC quarreled with the taking of discounts from the lattice or market-simulation values used to set the share value when features used to justify the discounts are not part of the shares used as the basis for lattice or market simulations, E&Y said.

E&Y also warned that when presenting cash flows in financial statements involving discontinued operations, issuers should not aggregate cash flows of discontinued operations in a single line item, but should detail separately the cash flows for operating, investing, or financing activities.

The SEC also pointed out issuer errors on pension accounting under the new FAS 158, *Employers' Accounting for Defined Benefit Pensions and Other Postretirement Plans*, in which issuers ''incorrectly reflected the transition adjustment on adoption,'' E&Y said. ''Some registrants have incorrectly reflected the transition adjustment as a component of other comprehensive income in the year of adoption, rather than as a component of ending accumulated other comprehensive income, as required by Statement 158.''

More MD&A Detail. E&Y have also noticed the SEC asked issuers for more detail in the management discussion and analysis section of the statements to ''describe and quantify the underlying causes of all material changes in financial statement line items and provide a more detailed analysis of material period-to-period changes.''

''The SEC staff typically requests that registrants provide more granular quantification and discussion about specific factors'' causing changes, E&Y said. ''For example, when MD&A cites two or more qualitative reasons that contributed to a material period-to-period change in a financial statement line item, the SEC staff requests that each reason be quantified and analyzed to provide more meaningful disclosure.'' E&Y noted that the SEC also wants to know if the reasons reflect trends that could produce future material effects.

The SEC also asked for better analysis of critical accounting issues that might affect the outcomes on the financial statement, especially certain items' sensitivity to changed conditions that are ''reasonably likely to occur'' and that would produce a material effect, E&Y said. The firm cited stock-based compensation for additional discussion in the MD&A, especially discussion of ''significant factors, assumptions and methodologies used in determining the value of stock options, such as the valuation method'' and the assumptions underlying the choice of a particular valuation method.

The SEC also has asked for similar analysis of valuation methods used in describing goodwill impairment and that can often lead to requested revisions to ''critical accounting policy disclosure,'' E&Y said.

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