Speech by SEC Staff:
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by

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Introduction

This afternoon I'd like to share some observations on three accounting topics that we have considered during the past year. They include: the accounting for litigation settlements; the recognition of FIN 45[1] guarantees in a spin-off transaction; and the application of paragraph 17c of SFAS 141.[2]

Accounting for Litigation Settlements

During the past year we have been consulted by many registrants on the accounting for litigation settlements. Your initial reaction to this statement is likely to be "why" since the accounting for litigation is within the scope of Statement 5[3] and is fairly well known. Well, to demonstrate the challenges that can arise with the accounting for litigation settlements, I'd like to share a typical settlement arrangement with you. Assume a company pays cash and conveys licenses to a plaintiff in order to settle a patent infringement and misappropriation of trade secrets claim. In exchange for the payment and licenses given, the company receives a promise to drop the patent infringement lawsuit, a covenant not to sue with respect to the misappropriation of trade secrets claim, and a license to use the patents subject to the litigation.

Elements of the Arrangement

To properly account for this arrangement, a company must identify each item given and received and determine whether those items should be recognized. We have found that errors generally occur when registrants don't fully consider the nature of each item. In the fact pattern that I just described, a settlement component obviously exists which most registrants recognize. Some registrants have also recognized an intangible asset for the covenant not to sue and for the patent licenses received. In certain cases, we have found that covenants not to sue with respect to a trade secrets claim don't identify which trade secrets a company may have infringed upon or convey a right to use them. Companies have also told us that the trade secrets they may have infringed upon could have been obtained by legal means in the marketplace. In these instances we believe that the covenant not to sue may not meet the definition of an asset or have value to a marketplace participant. We also believe that recognition of an intangible asset for the patent licenses received depends upon, among other things, whether the company has exclusive use of the patents or the right to sell or transfer them. When a company doesn't have these rights, we believe that it may be more appropriate to characterize and value them as a prepaid royalty. The last component of the arrangement that I'd like to talk about is the licenses given by the company. If the licenses are expected to be used by the plaintiff in their operations, it may be appropriate for the company to recognize revenue or income with a corresponding increase in litigation settlement expense. However, if the licenses are given as part of a litigation defense strategy and don't have value to the plaintiff, it seems unlikely that any revenue should be recognized.

Allocating Consideration to Each Item

An additional challenge that may arise when accounting for a litigation settlement is determining the proper allocation of consideration among the recognizable elements. While EITF 00-21[4] was written for multiple element revenue arrangements, we believe that its allocation guidance is also useful to determine how to allocate consideration paid in a multiple element legal settlement. In this regard, we believe that it would be acceptable to value each element of the arrangement and allocate the consideration paid to each element using relative fair values. To the extent that one of the elements of the arrangement just can't be valued, we believe that a residual approach may be a reasonable solution. In fact, we have found that many companies are not able to reliably estimate the fair value of the litigation component of any settlement and have not objected to judgments made when registrants have measured this component as a residual. In a few circumstances companies have directly measured the value of the litigation settlement component. In the fact pattern that I just described, the company may be able to calculate the value of the settlement by applying a royalty rate to the revenues derived from the products sold using the patented technology during the infringement period. Admittedly, this approach requires judgment and we are willing to consider reasonable judgments.

Classification of the Settlement

In the fact pattern that I've talked about so far it would be appropriate to record the consideration allocated to the litigation within operating expenses since the company did not have a prior relationship with the plaintiff. However, we believe that a different answer may result if the plaintiff is also a customer of the defendant. Assume a company settles a claim for over billing its customers for an amount that is in excess of the amounts they over billed. The company believed that the excess payment was necessary to preserve the customer relationship and had induced the customer to settle the claim. In this case we do not believe that classification of the entire payment as a settlement expense would be consistent with existing GAAP. Since the settlement payment was made to the company's customers, we believe that the payment is within the scope of EITF 01-9.[5] As you may know, this EITF addresses the accounting for consideration given by a vendor to a customer. The scope is broadly written and includes all consideration given by a vendor to a customer. It also requires that cash consideration paid be classified as a reduction of revenues unless the vendor receives an identifiable benefit and the fair value of that benefit can be reliably measured. In this fact pattern, we believe that the excess amount paid to the customer represents both a payment to retain the customer and settle the litigation. However, if the company is unable to determine the fair value of each of these components, we believe that EITF 01-9 requires the entire payment to be classified as a reduction of revenues. Had the company been able to directly value the litigation, classification of that portion of the settlement payment as an expense may have been appropriate.

Consideration Received by a Customer as a Result of a Settlement

So far I've only talked about a defendant's accounting for litigation settlement payments. We have also been asked about the accounting for litigation settlements received by customers from vendors. If the recipient is a customer, we believe that the relevant guidance is located within EITF 02-16.[6] In most cases we believe that this EITF requires payments received by a customer to be recorded as a reduction of cost of goods sold. However, if the settlement payment received is clearly unrelated to the vendor/customer relationship, we would be willing to consider classification of the settlement as a gain. In any case, disclosure of the settlement and its classification is important for users to understand the judgments you have made.

In summary, accounting for litigation settlements requires judgment in determining the elements within the arrangement, when to recognize those elements, and the value to allocate to them.

FIN 45 — Guarantees

The next topic that I'd like to discuss briefly is the recognition of FIN 45 guarantees. We have considered a number of transactions where a parent provides an indemnity for certain lawsuits to its wholly owned subsidiary prior to a pro rata spin off. Since FIN 45 doesn't require guarantees issued between a parent and its subsidiaries to be recognized, registrants have

concluded that subsequent to the spin-off the former parent doesn't need to recognize the guarantee. Registrants have noted that pro rata spin offs are recorded at the carrying amount of the net assets transferred after adjustment for any impairment and believe that this supports the view that no accounting should be required for the guarantee by the former parent. We do not believe that this conclusion is consistent with FIN 45. We believe that the FIN 45 parent-subsidiary scope exception applies only during the parent-subsidiary relationship since the guarantee is not relevant to the consolidated financial statements. Further, in a spin-off transaction the parent often has the ability to retain, modify or rescind the guarantee. The decision to retain any guarantee is the same as issuing a new guarantee at the date of the spin off when the parent-subsidiary relationship no longer exists. While the example that I just discussed related to an indemnification for legal settlements, we believe that other guarantees including tax indemnities should also be recognized by the guarantor.

SFAS 141 — Application of Paragraph 17c

Before concluding, I'd like to clarify some misconceptions about views that have been attributed to the SEC Staff on the application of paragraph 17c of SFAS 141. This paragraph is one factor considered when identifying an acquirer in a business combination. It requires you to evaluate the composition of the board of directors of the combined entity. In evaluating paragraph 17c, consideration of how long each board member is entitled to hold their position and whether they represent the majority or minority shareholders of the combined entity may be necessary. The goal is to determine whether control of the board by any shareholder group is temporary and, therefore, control may not be substantive. This is particularly important in situations where the board of directors of the combined entity is dominated by members that represent the minority shareholders' interests. In this situation many have asserted that the staff employs a bright line. Some believe that we won't accept a conclusion that the minority shareholder controls the board if its members control for a period of less than two years, three years and sometimes even five years. I'd like to tell you we have no bright line and simply believe that control of the board should be substantive. I'd also like to emphasize that we understand that judgment may be required in applying paragraph 17c.

Thank you for your attention this afternoon.

Endnotes

[1] FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*.

[2] FASB Statement No. 141, *Business Combinations*.

[3] FASB Statement No. 5, *Accounting for Contingencies*.

[4] Emerging Issues Task Force Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*.

[5] Emerging Issues Task Force Issue No. 01-9, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)*.

[6] Emerging Issues Task Force Issue No. 02-16, *Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor*.

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